



European Labour Network for Economic Policy

Financial crisis threatens
employment and growth

Policy response needed

Euro area economic forecast by the
European Labour Network for Economic Policy

May 2008

Executive summary

In spring 2008, the outlook for euro area growth is overshadowed by the ongoing financial crisis and the question of how deep the US recession might become. Financial distress worldwide is far from over and the necessary depreciations and write-offs in the banking sector will negatively impact the real economy. Weaker US and global expansion, combined with the appreciation of the euro against the US-dollar, will dampen euro area exports. At the same time, private consumption is impaired by rapid inflation primarily caused by unusually high prices for food and energy. The higher headline inflation rates will make the needed quick counteraction by policymakers, specifically a loosening of ECB monetary policy, less likely.

Key forecast figures for the euro area			
% change on previous year			
	2007	2008	2009
Gross domestic product	2.6	1.6	1.5
Private final consumption expenditure	1.5	1.5	1.5
Government consumption expenditure	2.2	1.7	1.6
Gross fixed capital formation	4.3	3.1	1.4
Exports ¹	6.0	4.0	4.1
Imports ¹	5.2	3.5	3.6
Net exports of goods and services ²	0.4	0.3	0.3
Employment	1.8	1.1	0.7
Unemployment rate ³	7.4	7.1	7.1
Collectively agreed wages	2.2	3.0	2.9
Unit labour cost	1.5	2.0	1.8
Inflation (HICP)	2.1	2.9	1.9
Budget surplus/deficit ⁴	-0.8	-0.9	-0.8
¹ includes intra-area trade. ³ % of the labour force. ² contribution to growth. ⁴ % of nominal GDP. Source: OECD, EUROSTAT, ECB, ELNEP forecast.			

Under these conditions the ELNEP forecasts euro area GDP to fall by a full percentage point to 1.6% in the current year, despite a probably still robust first quarter. Private consumption will stay feeble, hit by higher price increases, and all the other main demand

components will weaken. Growth will not pick up significantly until the end of 2009 at the earliest, and we predict an annual average of just 1.5%. The welcome fall in unemployment will come to a halt at 7.1%.

Currently at rather high rates of 3.6%, inflation is expected to decline during the forecast period, averaging 2.9% this year and returning to the ECB target of 1.9% next year, as the price shocks to energy and food prices drop out of the numbers. Despite the price hikes we expect collectively agreed wages in the euro area to grow by only 3.0% in the current year. Even allowing for slightly faster growth in actual wages, unit labour cost growth – the key metric for domestic price stability – will be 2.0% this and 1.9% next year: wage setting is underpinning medium-run price stability and second-round effects are not expected for the euro area as a whole.

For at least two years, then, the combination of external shocks and the financial crisis will bring an end to the brief period of strong growth that has brought down unemployment and helped to narrow fiscal deficits. Moreover, the downside risks to growth have intensified. ELNEP scenarios indicate that a stronger slowdown in the US and continued financial turbulence that keep inter-bank interest rates at elevated levels would reduce GDP in 2009 by 0.5% and cost 400,000 jobs compared with the forecast.

What should be the response of European policymakers in this situation?

Monetary policy: The ECB should swiftly cut its base rates by 50 basis points (half a percent) to stabilise consumer and business expectations and prevent an unnecessary and potentially drawn-out downturn in growth. ELNEP scenario calculations suggest that such a cut (followed up by the two cuts at the end of the year assumed as part of the forecast) would add 0.3 percent to GDP next year, adding 200,000 jobs and ensuring that unemployment continues to fall, albeit slightly. The cost in terms of higher inflation would be negligible.

Fiscal policy: Provided monetary policy acts to underpin economic activity, fiscal policymakers in most euro area countries need not take explicit counteraction, unless the economic situation takes an unexpected turn for the worse. However, they should allow the built-in stabilisers to work in full, accepting the slight rise in deficits that come automatically through higher spending and reduced tax revenues. Some countries, notably Spain and Ireland, particularly hard hit by the crisis and with strong budgetary positions, should use discretionary fiscal policy to support demand. More generally fiscal policymakers should be seeking to raise public investment in areas that promote longer-run growth.

Wages policy and collective bargaining: The ELNEP encourages wage-setters to stick to the forecast course: the average rate of wage increases is set to accelerate slightly, which will help sustain demand and consumption, but in aggregate remain compatible with

medium-run price stability in the face of temporarily higher inflation. Keeping wage increases to a rate not greater than the sum of labour productivity growth and the central banks inflation target, frees monetary authority to take resolute action to prevent a serious downturn. At the national level the slight wage acceleration in, notably, Germany, and deceleration in countries such as Spain will go some way to correcting the competitive imbalances that have built up within the euro area.

Financial market regulation: Urgent steps need to be taken to ensure that financial market actors behave in ways that promote, rather than endanger, the growth of the real economy. Past liberalisations and the successful efforts of financial market institutions to evade existing regulation have been shown to be highly dangerous. The most important short-term aim is to restore the functioning of financial markets, but the means chosen to achieve this aim should avoid socialising the losses of institutions that in the past successfully privatised their gains. In the medium term effective re-regulation of the financial sector is needed to: ensure transparency, prevent undue risk-taking and risk distribution, ensure adequate safety buffers (capital adequacy) in ways that reduce rather than promote economic instability, provide for European and international coordination and, where appropriate, the centralisation of supervisory authority, to prevent national jurisdictions being played off against each other.

More and better jobs? – Labour market developments in the euro area since 1999 – Executive summary

In a companion report the ELNEP network has analysed in detail the labour market of the euro area since the start of monetary union in 1999. In many important senses the euro area labour market performs better than its widely held reputation would suggest. Most notably, job growth has been strong, especially for women, and unemployment, although still higher than in the US, has fallen markedly. Europe has indeed created ‘more jobs’. However, there are a number of serious issues in the area of ‘job quality’ in the broad sense. More jobs: yes. Better jobs: not really.

Specifically ELNEP finds:

- Progress has been made in raising employment rates, but the Lisbon employment targets will not be met by 2010 because of the mid-decade ‘wasted years’ of sluggish economic growth.
- Unemployment has come down to levels not seen for a generation. Yet it remains higher than in the US and the non-EMU western European countries.

- In spite of lower unemployment and higher inflation, wage setting remains moderate and consistent with price stability in EMU as a whole. But this also means that national income continues to be shifted from wage to profit income, depressing the wage share.
- At the same time, divergences between countries unit labour cost developments have led to competitive tensions within the currency union.
- The euro area has a productivity problem. Contrary to standard arguments about the productivity-enhancing effects of market-oriented structural reforms, labour productivity growth has been sluggish. While the reasons are complex, we identify the weakening of collective bargaining, which has reduced the pressure on firms to rationalise production, as an important cause.
- Regarding job quality, there are a number of important areas of concern. Involuntary part-time work and the use of fixed-term contracts have increased inexorably. In a number of countries, but not all, wage inequality has increased dramatically. Specifically the share of workers in Germany and the Netherlands earning less than two thirds of the median hourly wage is now almost as high as in the USA.
- A quantitative analysis of job quality in the EU15 using fifteen separate indicators suggests a worrying decline in the areas of non-standard employment contracts and collective interest representation since 2000. Despite the shift to services and political statements of intent, there has been no improvement in 'physical' working conditions or in indicators of 'work-life balance'. Comparing countries on their overall performance, the Scandinavian countries come out top, along with the Netherlands and the UK. The southern European countries perform worse. Worryingly the better-performing countries have improved their scores since 2000, whereas the laggards appear to have fallen further back.

Overall the analysis suggests a link between these developments. Returning to pay trends that are oriented towards medium-run productivity growth, particularly at the bottom end of the labour market, would be an important step towards raising workers' living standards. It would help stop the trend to greater inequality, while serving to stimulate the rate of labour productivity growth on which, ultimately, rising living standards depend.

The data cut-off point for this forecast was 27 April 2008.

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ELNEP economic forecast and policy recommendations May 2008

Introduction

In spring 2008, the outlook for euro area growth is overshadowed by the ongoing financial crisis and the question of how deep the US recession might become. The reversal of the boom in the US housing market that initiated the financial turbulences is still under way and will take its toll on US consumption and investment, depressing US growth during the forecast period. The repercussions of weaker US import demand will slow down previously robust world growth rates. By how much, will depend on the severity of the US-recession.

At the same time, financial distress world-wide, especially in advanced economies, is far from over and the necessary depreciations and write-offs in the banking sector, beyond their immediate impact on the sector itself, will negatively impact the financial conditions of firms, as already indicated by banking surveys in the US and the euro area.

Weaker US and global expansion, combined with the appreciation of the euro against the US-dollar, will dampen euro area exports. At the same time, private consumption is impaired by unusually high price levels, especially for food and oil. Although those price increases are not due to internal euro area factors, the higher headline inflation rates will make the needed quick counteraction by policymakers, specifically

a loosening of ECB monetary policy, less likely.

Consequently, the ELNEP forecasts dampened growth rates of 1.6 percent in 2008 and 1.5 percent in 2009 for the euro area, a full percentage point lower than in 2007. Moreover, a prolongation or deepening of the financial crisis, a stronger recession in the US, and weaker global growth than assumed for the forecast constitute major downside risks for the ELNEP projections. In order to alleviate the problems in financial markets, limit the economic growth losses and reduce the chances of a more serious economic downturn in Europe, early interest rate cuts by the ECB are strongly recommended.

Euro area developments in 2007

In 2007, activity in the euro area continued to expand at surprisingly robust rates: at 2.6 percent, GDP growth was close to the rapid pace achieved in 2006. Yet, signs of strains increased towards the end of last year: Growth rates declined from 0.8 percent in the first quarter (q-o-q) to only half that figure in the last quarter. Investment, the main GDP driver in that year, expanded at lower rates than in 2006 and showed signs of an abating dynamic. Similarly, euro area export growth did not reach the 2006 levels, and quarterly growth rates declined at the end of last year. Yet overall, foreign trade

still contributed almost half a percentage point to euro area expansion, as import growth also slowed.

Consumption continued to expand only moderately in 2007, despite improved employment growth and a significant reduction in the unemployment rate. Yet the increase in consumer prices – that was essentially driven by the external factors food and energy – exceeded the moderate rise in wages and salaries. The slump in German consumption due to the VAT-increase at the start of 2007 additionally depressed the euro area figure.

Due to liquidity problems in the wake of the US housing market crash, interbank spreads in the euro area started to widen in relation to the target rate of the ECB in August, raising financing costs for banks. The ECB pumped in liquidity, offering to lend banks central bank money for longer periods, but this has so far not been able lastingly to restore normal functioning of the money market. In the face of the ever-increasing media reports of mounting waves of trouble in the banking sector, the appreciation of the euro, and rising prices, consumer and business sentiment worsened in the course of 2007 and continued to do so in the first

quarter of 2008. Leading economic indicators point to a slowdown of euro area growth in 2008.

Weakening global activity in 2008 and 2009

As has been mentioned in the introduction, world growth is expected to slow down during the forecast period (Table 1). The main reason for this is the expectation of a US recession. The reversal of the former boom in the US housing market initiated the financial turbulences and will dampen US growth via several channels.

Despite the sharp rate cuts by the US Federal Reserve, the higher credit cost level in 2008 compared to previous years, and the end of ‘teaser’ rates in the sub-prime market, will increase the cost of repayments and can be expected to accelerate the pace of foreclosures. House prices will continue to decline – on some estimates an overall correction of some 30% in real house prices is required – dampening consumption expenditures, which in the past relied heavily on rising property prices facilitating ever-increasing consumer debt. The negative

Table 1

Assumptions of the forecast			
	2007	2008	2009
ECB target rate (%)	3.9	3.9	3.5
Three-month money market rate (euro area, %)	4.3	4.5	3.7
Yield on ten-year government bonds (euro area, %)	4.2	4.1	4.4
Exchange rate (USD/EUR)	1.37	1.54	1.50
Oil price (Brent, USD)	72.5	93.5	85.4
World growth (volume terms)	4.9	3.9	4.0
Source: National and international statistics, 2008 and 2009 Elnep assumptions.			

wealth effect on consumption is intensified by the simultaneous decline of stock market prices. At the same time, household incomes suffer – in real terms – from rapid consumer price inflation. Although the upsurge of prices will fade out in the course of the year, consumption expenditure will stay depressed for the forecast period.

Residential construction already shrank and non-residential investment in structures is expected to follow as credit conditions tighten and domestic profits falter. With the expectations of slowing growth, investment in equipment and software is likely to follow. However, net exports will further US growth, on the basis of the depreciated US-dollar.

The Fed reacted quickly and decisively. Monetary easing started in September 2007


and led so far to a reduction in the target rate by 300 basis points (from 5.25 percent to 2.25 percent). The decrease in the policy rate was accompanied by broadened liquidity provision to the financial sector. Although the chosen measures aimed at alleviating financing conditions, banking surveys indicate an ongoing deterioration for firms and private households. Yet monetary easing should show positive effects on investment later on in the year, provided banks' liquidity problems abate and the financial system stabilises.

As a consequence, the ELNEP expects the US to experience a modest recession in the first half of 2008. In the second half of this year, growth should pick up slightly, bolstered by the fiscal stimulus package and monetary easing (Table 2). However, the

Table 2

Key indicators of selected countries									
	GDP			Consumer prices¹			Unemployment rate		
	% change on previous year			% change on previous year			in %		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Austria	3.3	2.1	1.7	2.2	2.9	2.3	4.4	4.2	4.3
Finland	4.3	3.0	2.8	1.6	3.2	2.3	6.9	6.3	6.0
France	1.9	1.6	1.7	1.6	2.8	2.0	8.3	7.8	7.9
Germany	2.6	1.6	1.4	2.3	2.6	1.6	8.4	7.4	7.5
Italy	2.2	0.8	1.1	2.0	2.9	1.9	6.1	5.7	5.5
Netherlands	3.5	2.3	1.8	1.6	2.5	2.8	3.2	4.0	4.3
Spain	3.8	2.4	2.0	2.8	3.8	2.8	8.3	9.1	9.6
Euro area	2.6	1.6	1.5	2.1	2.9	1.9	7.4	7.1	7.1
Denmark ²	1.8	1.4	1.1	1.7	2.7	2.2	3.7	3.0	3.3
Sweden	2.6	2.0	2.2	1.7	3.4	2.6	6.1	5.6	5.6
European Union	3.1	2.0	1.9	2.4	3.1	2.3	-	-	-
USA	2.2	1.0	1.5	2.5	3.0	2.7	4.6	5.1	5.5
Japan	2.1	1.5	1.6	0.0	0.7	1.3	3.9	3.9	3.9
China	11.4	9.5	9.5	4.8	6.0	3.5	-	-	-
World economy	4.9	3.9	4.0	4.0	4.8	3.7	-	-	-

¹ HICP for the euro area, ² Harmonized unemployment rates are 1 percentage point above the national definition.
Source: Eurostat; national & international statistics; 2008 and 2009 Elnep forecast.



downside risk in the form of a deeper recession and a continued financial crisis remains considerable, as declining asset markets and a stagnant or contracting real economy can interact in unpredictable and cumulative ways.

Slowing US demand on world markets will not be compensated by higher growth rates in the rest of the globe: Japan and the Asian economies are expected to lose steam – as a consequence of the weakening US economy, tighter monetary conditions and the price surge for raw materials. The Asian economies and some other regions like South America and Russia are, however, still growing comparatively fast. China, for example, although it will suffer the same dampening effects from the aforementioned sources, will still grow at rates above 9 percent (Table 2).

Most of the central and east European New Member States of the European Union will continue to grow at higher rates than the euro area average, nevertheless being affected by weakening world demand.

As a result, world growth (in volume terms) is expected to decline from about 5 percent in the previous two years to below 4 percent this and next year. The ELNEP assumes that a modest recession in the US economy is already priced in by financial and foreign exchange markets, as is a further interest rate reduction by the Fed. Yet the negative effects of slowing US demand on euro area growth seem to be slightly underestimated by financial markets. Once the slowdown in the euro area becomes apparent, the euro will be expected to depreciate. Thus overall

we expect the EUR/USD exchange rate to stabilise over the forecast period at roughly 1.50 (Table 1).

Given weakening world demand, oil prices are expected to descend marginally from their current elevated levels, resulting in an average price of about 94 USD in 2008 and 85 USD in 2009 (Table 1). Food prices on world markets are also expected to moderate. The risk remains, though, that the projected slowdown of the global economy will not sufficiently dampen the price upsurge for oil and raw materials. Although financial speculation on raw materials should decrease in the future and thereby reduce prices, maybe even quite abruptly, to forecast the exact timing of this effect seems impossible.

Expansion in the euro area will distinctly weaken

Up to now, the euro area has not been hit as hard by the current crises on global financial markets as the US. However, deteriorating growth expectations for the US have gradually worsened the euro area outlook. The ELNEP forecasts 1.6 percent GDP expansion in 2008, around one percentage point less than in 2007. The yearly figure actually overstates the dynamics, as the carry-over-effect from the high dynamics in 2007 accounts for roughly 0.7 percentage points. In 2009 growth is expected to amount to 1.5 percent (Table 3 and Figure 1).

Table 3

Key forecast figures for the euro area			
% change on previous year			
	2007	2008	2009
Gross domestic product	2.6	1.6	1.5
Private final consumption expenditure	1.5	1.5	1.5
Government consumption expenditure	2.2	1.7	1.6
Gross fixed capital formation	4.3	3.1	1.4
Exports ¹	6.0	4.0	4.1
Imports ¹	5.2	3.5	3.6
Net exports of goods and services ²	0.4	0.3	0.3
Employment	1.8	1.1	0.7
Unemployment rate ³	7.4	7.1	7.1
Collectively agreed wages	2.2	3.0	2.9
Unit labour cost	1.5	2.0	1.8
Inflation (HICP)	2.1	2.9	1.9
Budget surplus/deficit ⁴	-0.8	-0.9	-0.8
¹ includes intra-area trade. ³ % of the labour force. ² contribution to growth. ⁴ % of nominal GDP. Source: OECD, EUROSTAT, ECB, ELNEP forecast.			



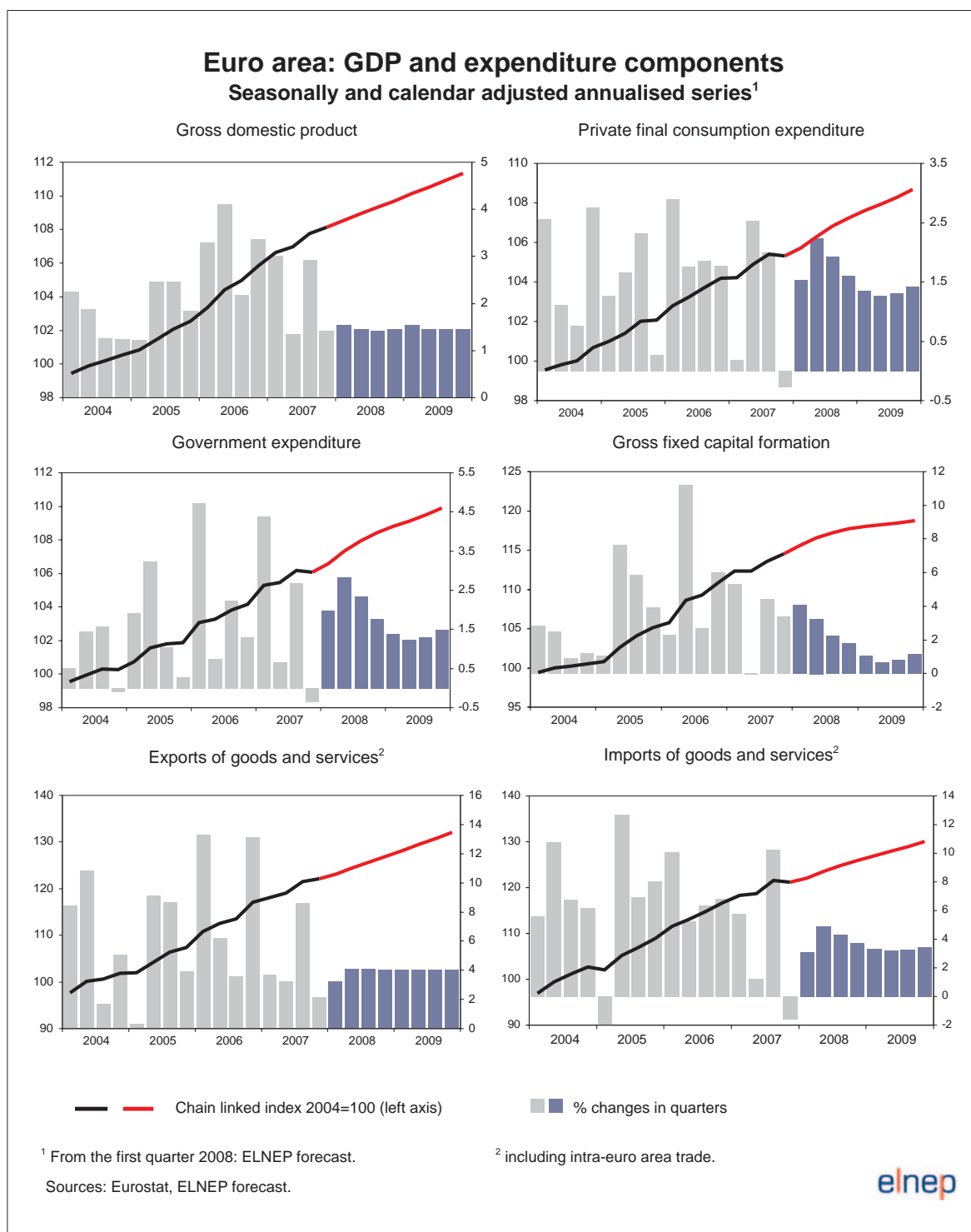
The ELNEP expects private consumption growth of around 1.5 percent in both years, roughly in line with the rather modest rates we have seen in the last four years. That is due to the fact that the expected increase in total gross wages will mainly be compensated by consumer price inflation.

Government consumption should follow its past pattern of increasing marginally below 2 percent. Consequently, the expected slowdown in domestic demand is not driven by consumption, but instead by a deceleration in investment, not only in construction but also in machinery and equipment. The growth rate of gross fixed capital formation is projected to fall by more than one percentage point each year, from 4.3 percent in 2007 to 1.4 percent in 2009. Furthermore, the downsizing in stock

building is projected to decrease GDP growth in 2008 by 0.5, and in 2009 by 0.3 percentage points.

The reason for the pessimistic investment outlook is the more restrictive monetary environment due to the past increases in the ECB policy rate that have raised the overall interest level. In addition, credit conditions worsened due to the financial turbulences, and are expected to deteriorate even further, as ECB banking surveys already indicate. Declining share prices and stronger risk aversion on the part of international investors, demanding higher risk premia, add to the worsening of financial conditions for firms. Exporters' investment will be curtailed by the high euro. The projected late and modest decrease in the target rate of the ECB by 25 basis points in the third quarter

Figure 1



and another 25 basis points in the fourth quarter will hardly be felt at all in 2008 and only slightly alleviate the decline in investment in 2009.

Compared to the previous four years, the ELNEP is forecasting considerably lower exports growth rates. This is based on the appreciation of the euro, most pronounced against the US-dollar, and the slowing world demand that will both weigh on euro area exports. At the same time import growth is also projected to lessen. That is in line with the assumption of modest consumption growth, slowing investment, and the higher share of export-related imports. Overall, net exports will still positively contribute to GDP growth, albeit less than in the past.

Despite sluggish GDP growth, unemployment is expected to slightly decrease in 2008, but will rise marginally in 2009. Yet even if the developments do not show up in the annual average rates, which are unchanged at 7.1 percent, this marks a turnaround in labour market developments: the steady reduction in unemployment of recent years is expected to come to a standstill for (at least) a two-year period.

As explained in more detail in the section on wage policy below, nominal wage increases are expected to pick up somewhat, but will not exceed trend productivity growth plus the ECB's inflation target of 'close to, but slightly below' 2 percent. This is reflected in the forecast for unit labour cost, whose growth rate will temporarily reach 2 percent in 2008 and decline to 1.8 percent in 2009. Therefore, euro area wage developments pose no threat to price stability.

While internal price and wage developments have been benign, external factors like the sharp increase in oil and food prices did significantly impact euro area inflation in the past months, driving the yearly inflation rate up to 3.6 percent in March 2008. Yet, the upward pressure on prices from oil and food will fade in the coming months and lead to a return of the inflation rate to the ECB's target during the forecast period. Nevertheless, the average inflation rate will be pushed up to 2.9 percent in 2008 due to high carry-over effects. For 2009, consumer price growth is expected to meet the ECB's inflation target. During the forecast period as a whole, much of nominal wage growth will be eaten away by price inflation; real wage growth will be very sluggish, limiting the scope for private consumption to expand.

Although current consumer price inflation in the euro area is distinctly above the ECB's target, the ELNEP expects two reductions of the policy rate by 25 basis points in the third and fourth quarter of 2008, respectively (see the section on monetary policy below). By then, upward pressure on prices will have faded and leading economic indicators will unambiguously have signalled a slowdown in euro area expansion. Unit labour cost growth has been below 2 percent recently and core inflation – inflation excluding energy, food and tobacco – has not risen above 2%. Both variables are not expected to exceed this figure during the forecast period. At the same time, inflation expectations for the medium term are well anchored around the ECB's target, according to the Eurosystem's survey of professional forecasters. That the ECB will probably not react before autumn is due to the assessment that the ECB is primarily concerned about

jeopardising its reputation for fighting inflation – even if that might hamper euro area growth.

Risk scenarios

The ELNEP forecast rests on the assumptions presented in Table 1 above. However, there are a number of risks that the underlying assumptions will turn out to be incorrect. Indeed, in the current uncertain environment, these risks are even greater than normal. Therefore, the following risk scenarios have been calculated in order to shed some light on the effect of modified assumptions on the forecast for euro area outcome. This also gives clues as to appropriate policy stances. Like the forecast itself, the simulations were carried out using the econometric model HEIMDAHL of the Danish partner institute ECLM. First, two upside risk scenarios are presented:

- A quicker and stronger reduction of the ECB's main refinancing rate by an additional 50 basis points.
- A depreciation of the Euro by five percent

Given actual developments we need especially to consider downside risk scenarios, of which the following two have been estimated:

- A more severe slowdown of the world economy than assumed in the forecast, modelled as a one percentage point lower GDP growth rate in the US in both years 2008 and 2009.

- A more severe slowdown of the world economy combined with persistent financial uncertainty resulting in higher risk premia than in the past; this was modelled by higher short-run interest rates in the interbank market, leaving the assumptions on central bank target rates unchanged.

Scenario 1: A quicker and stronger reduction of the ECB's main refinancing rate (by an additional 50 basis points)

The following scenario illustrates how the ECB could shore up euro area growth by an earlier and stronger reduction of its target rate. In this scenario the ECB does not wait until autumn for the first step, as assumed in our baseline, but instead immediately (in May 2008) cuts its main refinancing rate by half a percentage point (50 basis points). Then, as in the baseline scenario, two additional cuts by 25 basis points each follow in the third and fourth quarter. In effect, the target rate would be reduced by 100 basis points compared to only 50 basis points in the baseline scenario.

Assuming that the cut in the main refinancing rate would be reflected in interbank rates and the overall interest rate level, GDP would expand by additional 0.3 percent in 2009 compared to the baseline forecast (figure 2). The stronger expansion is due to the fact that the interest rate reduction would not only stimulate investments but also private consumption, both directly and furthered by multiplier effects. On account of increased demand,

employment in the euro area would rise by nearly 200,000 persons. This would be reflected in lower unemployment.

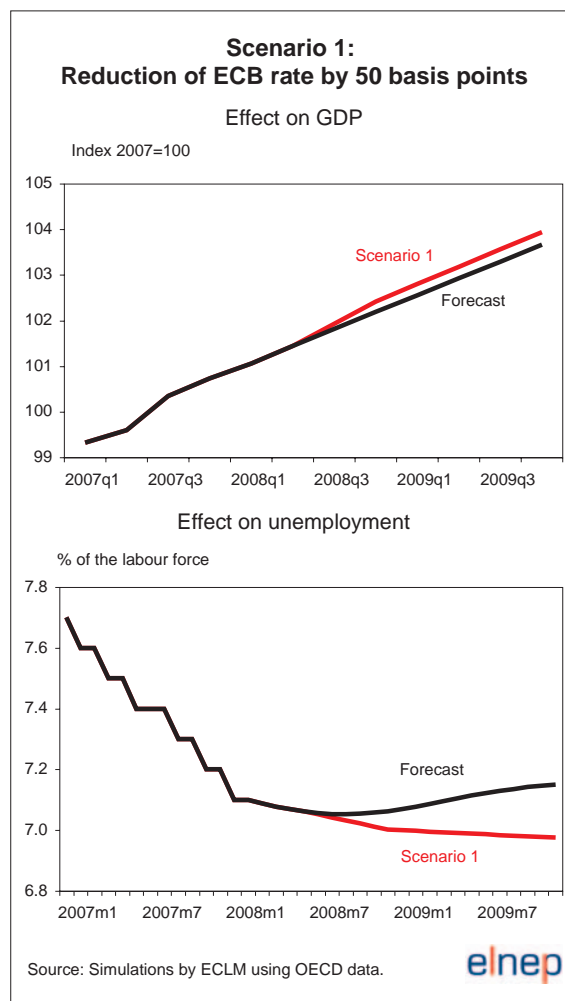
However, higher demand growth and lower unemployment would be expected to cause upward pressure on prices. Yet, the model calculations show that this effect is negligible: consumer price inflation would increase by only 0.05 percent in both years 2008 and 2009, resulting in a total additional effect on the consumer price level of 0.1 percent in 2009 compared to the baseline.

As illustrated in figure 2, the quicker interest rate reduction would result in a continually declining unemployment rate over the forecast period. A more expansive monetary policy stance would therefore not only support euro area growth, but also prevent the otherwise forecast turnaround in unemployment. The cost of such action in terms of additional inflation would be negligible.

Scenario 2: A depreciation of the euro

Interest rate cuts by the Federal Reserve and the increasing danger of a US recession have furthered the recent appreciation of the euro against the US-dollar, leading to unprecedented highs of the EUR/USD exchange rate. The baseline forecast assumes that the exchange rate stays at that elevated level. There is a chance, though, that the US-dollar will regain some of its lost ground against the euro. One reason for a slight reversal could be based on the assessment that international investors overreacted to the possibility of a deep US recession or overestimated the probability

Figure 2



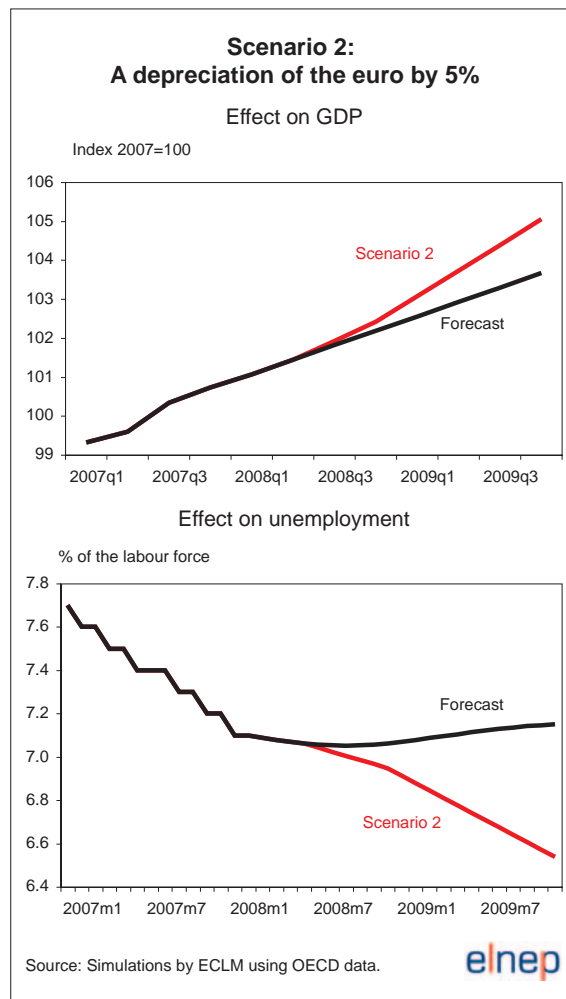
for it. Conversely, euro area growth estimates up to now might have been too optimistic, underestimating the repercussions of slowing US growth on the European economy. In both cases, the euro would depreciate, should investors change their assessment and adjust their portfolios accordingly. (A stronger reduction in the ECB target rate as suggested in the first risk scenario would also push in the direction of a lower euro exchange rate against the dollar).

The scenario models the effect of the euro gradually depreciating against the US-dollar in the course of 2008, overall losing 5 percent in value during that year. From the beginning of 2009, the exchange rate is assumed to stay at this level. According to the model, the depreciation by 5 percent would boost GDP in the forecast period by as much as 0.9 percent compared to the baseline. The expansionary effect results from the combination of increased exports, lower import growth, and knock-on effects from exports to investment and output. Higher GDP growth would eventually enhance employment by nearly 700,000 persons over the two years' period. This would be reflected in an unemployment reduction of as much as 0.4 percentage points compared to the baseline (figure 3).

The increase in euro area GDP in reaction to a 5 percent depreciation of the euro against the US-dollar is surprisingly high. This result has to be interpreted with caution, though, as the model might overstate the real effect. In the model, a change in the EUR/USD exchange rate translates into a corresponding change in the effective exchange rate of the euro. Yet, various Asian exchange rates seem to have loosened their ties to the US-dollar in the recent past. The Chinese yuan, the Indian rupee and the Japanese yen are examples of currencies that used to follow the dollar exchange rate quite closely, but have recently appreciated against the dollar. As the importance of Asian economies for euro area growth has risen in the past, a cautious interpretation of the model results is all the more called for.

On the other hand, negative repercussions of the stronger euro on growth should not be underestimated. That euro area exports have

Figure 3



not yet suffered remarkably, despite the euro appreciation, is in all probability to be attributed to the strong world demand, counteracting the price effect. Especially in the new EU-member states and Asia, growth has been very robust. Unfortunately, this positive effect is projected to lessen during the forecast period. The restrictive effects of appreciation may come with a lag, as firms initially absorb a higher-valued currency in their profit margins. The assumed 5 percent depreciation would therefore first go into restoring these damaged margins and would not in the first instance lead to higher export growth.

Scenario 3: A more severe slowdown of world demand

Slower world growth than the one assumed is one of the main downside risks for the ELNEP forecast. The economic developments in the US are an important indicator for overall world growth in general. The baseline scenario assumes that the financial crisis will weaken the US economy, but only lead to a mild recession. Yet the high probability of the US being hit harder by the financial crisis requires an analysis of the extent of the negative impact on the euro area economy.

Following the model estimates, the implication of a one percentage point lower US growth rate in both years 2008 and 2009 would result in a considerably stronger slowdown of the euro area economy than forecast in the baseline. Euro area expansion in 2009 would be reduced by 0.3 percent. The negative repercussions from reduced US demand would directly lower euro area exports, indirectly weakening investment and private consumption and the demand for labour in the euro area. Overall, employment losses would amount to 300,000 persons in 2009 compared to the baseline, corresponding with an increase in the unemployment rate (figure 4).

Scenario 4: A more severe slowdown of world demand plus a continuation of the financial turbulences

A deeper recession in the US economy is not the only relevant downside risk; it may be accompanied by lasting financial turbulences. Due to the current liquidity

problems of banks, spreads between short term interbank rates and the ECB target rate have widened to a historically exceptional degree (see the section on monetary policy). Should these high spreads persist during the forecast period, the overall interest rate level would remain higher than assumed in the baseline, even if the ECB lowered its target rate.

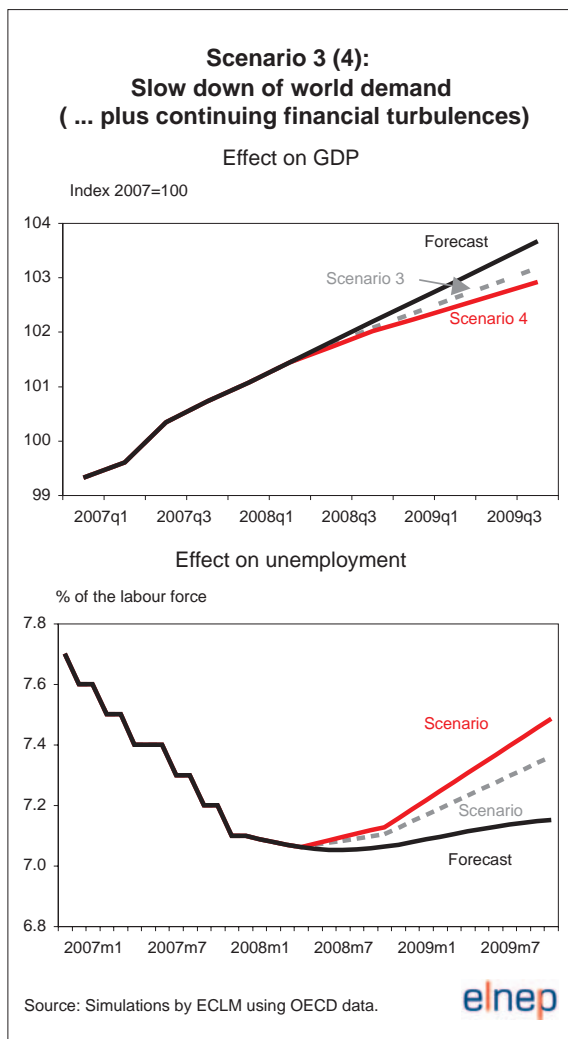
The combined effect of a deeper US recession and persistently higher money market rates would dampen euro area GDP by 0.5 percent compared to the baseline. The loss in employment would rise to 400,000 persons. That would be reflected in an increase of the unemployment rate by 0.2 percentage points (figure 4).

Overall these scenarios suggest that policymakers, and especially monetary policy, which can react the fastest to changed circumstances, need to be highly vigilant and ready to take swift, but in no way dramatic, counter-action, in order to underpin growth in the euro area. According to the econometric model, the potential inflationary risk of 'taking out insurance' by adopting a more proactively expansionary monetary stance is negligible.

Evaluation of the spring 2007 forecast

Compared to the forecast made by the ELNEP network in April 2007, growth performance in 2007 proved to be slightly underestimated: Euro area GDP increased by 0.4 percentage points more than expected. The main driver for the discrepancy between forecasted (2.2 percent) and actual growth (2.6 percent) was net exports. Not only did

Figure 4



exports perform marginally better than expected, despite the stronger appreciation of the euro. But also – and quantitatively more importantly – imports remained below the projected levels, increasing the contribution of net exports to GDP (Table 4).

The expectation of higher import growth should be seen in connection with the slightly higher forecast for consumption (1.7 percent instead of the effective 1.5 percent). Private consumption stagnated in the first quarter of 2007 for the euro area, despite robust growth rates in all countries but Germany. While German consumption


rebounded in the second quarter, the VAT-effect on first quarter growth rates led to a reduced increase for the annual growth rate of private consumption. Government spending promoted growth more than expected and partly compensated for weaker private consumption. Likewise, investment performed slightly better than had been forecast.

At the start of 2007, euro area private consumption was driven by favourable developments in real disposable incomes and higher consumer confidence. Improvements in the labour market were a major contributing factor: employment growth was stronger and, consequently, the reduction in the unemployment rate was higher than projected, even though a change in German unemployment statistics in October raised the euro area average.

Price dynamics were understated: HICP inflation reached 2.1 percent in 2007, instead of the forecasted 1.8 percent, reflecting much higher increases in crude oil and food prices. By contrast unit labour cost growth remained even below the estimated 1.8 percent.

Compared with the forecast for 2008 made by the ELNEP network in April 2007, the current (end April 2008) evaluation of this years' economic situation has distinctly worsened. Growth prospects are overshadowed by the financial crisis, a more pronounced weakening of world demand than anticipated in spring 2007, and a stronger appreciation of the euro. In addition, the upsurge in consumer prices necessitates a higher inflation forecast and will put a strain on euro area consumption. Therefore, the growth forecast for 2008 is now substantially lower, 1.6 percent compared to 2.1 percent.

Table 4

Forecast evaluation for key figures of the euro area				
% change on previous year*				
ELNEP Forecast	in spring 2008		in spring 2007	
	2007	2008	2007	2008
Gross domestic product	2.6	1.6	2.2	2.1
Private final consumption expenditure	1.5	1.5	1.7	1.9
Government consumption expenditure	2.2	1.7	1.6	1.4
Gross fixed capital formation	4.3	3.1	4.1	3.3
Exports ¹	6.0	4.0	5.8	5.0
Imports ¹	5.2	3.5	5.7	5.0
Net exports of goods and services ²	0.4	0.3	0.1	0.1
Employment	1.8	1.1	1.3	1.0
Unemployment rate ³	7.4	7.1	7.3	7.0
Unit labour cost	1.5	2.0	1.8	1.4
Inflation (HICP)	2.1	2.9	1.8	1.8
Budget surplus/deficit ⁴	-0.8	-0.9	-1.2	-0.9
¹ includes intra-area trade. ³ % of the labour force. ² contribution to growth. ⁴ % of nominal GDP.				
Source: Eurostat, ECB, OECD, ELNEP forecast.				

Economic policy

The economic situation of the euro area is taking a turn for the worse. While in the previous year growth was still reasonably high, albeit not particularly buoyant compared to earlier upswings, our forecast for 2008 signals a significant slowdown. Its roots are located mainly outside the euro area, which makes it difficult for economic policy to react appropriately. In some cases it is even hardly possible to find short term solutions.

The biggest challenge is for monetary policy. It is, as the IMF puts it, torn between 'ice and fire'. The reason is the coincidence of the 'ice' caused by the financial market turmoil that is threatening growth performance, and the 'fire' of high

inflation rates caused by the steep increase of global energy and food prices. The real problem for monetary policy should be the ice. This is partly because the upsurge in prices is itself a burden for euro area expansion since it adversely affects profitability of European firms and real incomes of European private households. But the main reason is that the current 'fire' problem is fundamentally different to an excess inflation that is triggered by a domestic wage price spiral, where at least private households initially benefit in terms of spending power. Instead, price upsurges are being driven by external factors. In addition to that damper on growth, the significant appreciation of the euro will hamper exports. Therefore a more expansionary stance of monetary policy is appropriate to avoid a further weakening of

growth and guard against the risks of a more serious downturn.

The role of fiscal policy is complementary. Countries like Spain are more adversely affected than others by the downturn, and have fiscal ‘ammunition’. Their fiscal policy could provide additional help. But on the aggregate level of the euro area the fiscal stance may not change a lot and would worsen the improved performance on budget balances. It is important, though, that the automatic stabilisers – increased government spending and the reduced tax take resulting ‘automatically’ from the slowdown – should be left to do their work and help to counter the downturn. Given the expected downturn, the case for a restrictive policy like during the past two years is clearly over: the overall monetary and fiscal policy stance should be a bit more expansionary than previously.

To enable monetary policy to concentrate on limiting the drag on economic growth and maintaining employment, wage increases on the national as well as on the euro area level should be in line with productivity growth plus the ECB’s target: our forecast indicates that this can be expected to be the case during 2008 and 2009 in aggregate.

In the following sections the ELNEP presents in more detail its proposals in the areas of monetary, fiscal and wage policy, and regarding the need to resolve the financial crisis in an economically efficient and socially just way.

Monetary policy must do more to limit the downturn

Monetary conditions in the euro area have worsened considerably over the last 12 months. This is despite the fact that the European Central bank abstained from raising its main refinancing rate after June 2007 and prolonged its liquidity provision to banks in the face of the financial turbulences. Although the ECB target rate has remained stable at 4 percent since the last rise in June 2007, since August the interest rate on the interbank market for unsecured transactions (Euribor) has moved decidedly above the target rate (figure 5), reflecting the waves of distrust among banks once liquidity problems became apparent. The continuingly high spread – that is negligible in normal times – between the Euribor for unsecured and the Eurepo for secured interbank lending is a clear sign of the ongoing suspicion between banks (figure 5), despite the efforts by the ECB. Nevertheless, the broadened liquidity provision did alleviate pressures in the interbank market and should be continued as long as necessary.

The elevated interbank rates increase the finance costs for banks. Higher costs for banks will be reflected in higher credit cost for companies in the forecast period, as the banking lending survey conducted by the Eurosystem from January 2008 is already indicating: Responding banks reported that the net tightening of credit standards for loans to enterprises increased due to the financial market turbulences in summer 2007 and the worsening of banks’ balance sheets (Figure 5). At the time of the survey (i.e. before the latest wave of financial turmoil), a continuation of the net tightening

was expected. The worsening of lending conditions for households for house purchases was reportedly more limited (ECB Monthly Bulletin February 2008). Up to now, the pace of credit expansion has remained high – which might be interpreted as a sign that demand and supply of credits are not hampered, neither by availability nor by higher costs. Yet it is important to recognise that the current credit expansion to a considerable extent reflects conditions for company credits that were negotiated long before the awarding. In other words the credit contraction is in the pipeline.

Euro area enterprises are not only facing higher credit costs, but also a deterioration of alternative forms of financing investment: share prices dropped markedly. The EuroStoxx50 – an index of the 50 largest listed companies in the euro area – lost almost 20 percent in value between summer 2007 and the end of March. At the same time, investment financing by issuing bonds has become more expensive, at least for bonds that are not rated highest quality (AAA-rating). Bonds of medium grade quality (BBB) even have to pay an additional 250 basis points over the rate on government benchmark bonds, compared to less than 100 basis points before the crisis (Figure 5).

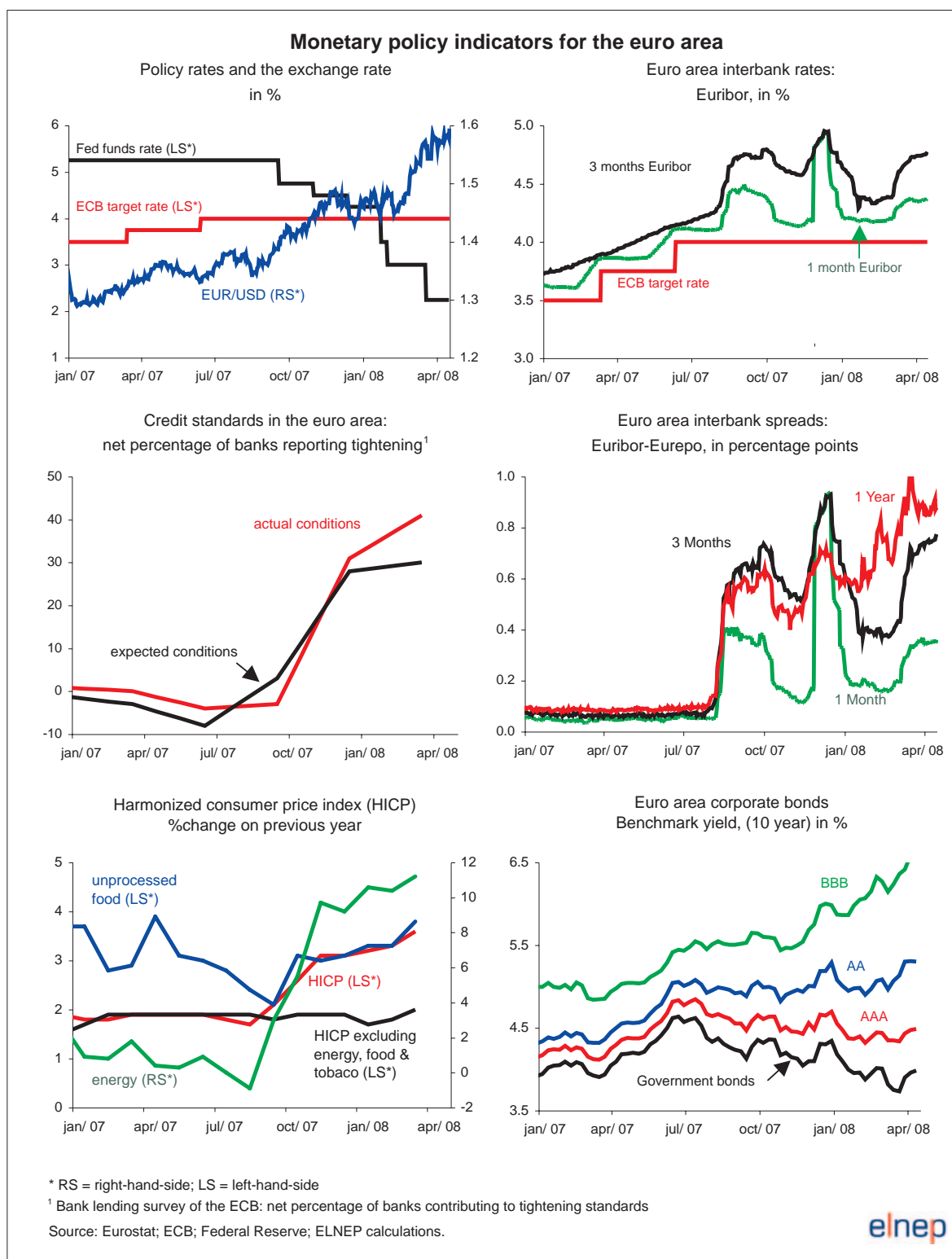
Further restrictive monetary effects are coming from the exchange rate. In 2007, the euro already appreciated by more than 10 percent against the US-dollar. Since the start of the year, the common currency gained another 8 percent (end of March) in value. On the one hand, the appreciation lowers import costs, but on the other, exports to countries whose currencies depreciated, are getting prohibitively expensive. Either the entire appreciation is shifted onto the export

price, hitting export demand, or firms have to absorb the appreciation in diminished profit margins, dampening domestic investment. Moreover, the ‘global players’ will see increasing incentives from the exchange rate to locate new investment in the dollar area rather than the euro zone, as this has become cheaper and serves as a ‘natural hedge’ against exchange-rate risk.

The combination of worsening financial conditions, weakening global growth, and deteriorated competitiveness via the exchange rate appreciation will force euro area growth below any reasonable estimate of ‘potential output’ (the rate of growth compatible with medium-run domestic price stability): by itself that calls for counteraction by the ECB. The appropriate response would be to cut interest rates, as the US Federal Reserve has done in dramatic fashion in response to the much more pronounced economic slowdown there. Regarding liquidity provision, as the ECB already extended its normal main refinancing operations, yet without managing lasting to stabilise interbank rates, more exceptional measures might be called for: One possibility would consist in regularly providing liquidity on longer terms, possibly combined with broadening the class of eligible assets that can be used as collateral (although the ECB has always been more ‘liberal’ in this regard than the Fed). In addition, ways might be found to reduce the cost of access to the marginal lending facility.

But what about inflation? Doesn’t the current rapid rate of consumer price inflation impede any lowering of central bank interest rates? In March the yearly inflation rate amounted to 3.6 percent, after

Figure 5



3.3 percent in February – substantially above the ECB’s target of close to, but slightly below 2 percent (Figure 5). Yet, the upsurge in consumer prices is almost entirely due to external, not internal factors, namely the sharp increases in crude oil and food prices in the past months. The upward pressure on prices from oil and food will fade in the coming months and lead to a return of the inflation rate to the ECB’s target during the forecast period – not only due to the dropping out of statistical base effects¹ but also due to the world-wide economic slowdown. Even so the average inflation rate will be 2.9 percent in 2008 due to high carry-over effects.

Although there is a widespread perception that central banks can control inflation whatever its source, it should be obvious that the ECB cannot do anything about higher imported prices. The only way that the ECB could reach its target in the short run is by raising interest rates to squeeze the economy sufficiently to depress euro area internal prices. This would not only be very costly but also unnecessary, as inflation driven only by external factors does not pose stability problems as long as inflation expectations for the euro area stay well-anchored and wage increases do not incorporate the price increases, leading to wage-price spirals. To sum up, as long as there are no fears of perpetuating the external price surges through higher inflation expectations, elevated inflation rates will remain a temporary phenomenon that does not require counteraction by a monetary authority whose focus is medium-term price stability.

Up to now, there are neither signs for wage-price-spirals nor for inflation expectations

getting out of line. The fact that core inflation (excluding energy, food and tobacco) has not yet exceeded 2 percent shows that the supply shocks have not been translated into euro area price setting (Figure 5). And unit labour cost growth has been below 2 percent recently and is not expected to exceed this figure at any time during the forecast period; for details see the section on wage policy below. At the same time, the survey of inflation expectations of professional forecasters, conducted by the ECB, shows that up to now medium term expectations have remained well anchored around the central bank’s target: They only slightly increased from 1.93 percent to 1.95 percent (ECB Monthly Bulletin, February 2008).

It is true that longer-term break-even inflation rates extracted from inflation-linked bonds and inflation-linked swaps have been on an upward trend since the beginning of 2007. The slight increase could reflect higher inflation expectations. However, the ECB itself warns that this interpretation might be misleading due to repercussions of the financial crisis, writing: ‘To sum up, sizeable liquidity effects in the government bond markets have recently complicated the interpretation of important indicators derived from bond market data. Specifically, it seems that temporary liquidity factors and their subsequent unwinding, rather than genuine changes in inflation expectations and inflation risk premia, have been the principal factor

¹ A base effect occurs when a variable’s annual rate measured from month t to month $t+1$ varies because of the changes in the variable’s level 12 months before, rather than because of the variation of the variable’s level between month t and month $t+1$. The *decline* in oil prices at the end of 2006, for example, would have led to higher measured inflation rates at the end of 2007 and beginning of 2008, even if the oil price had not risen in these months.

behind the recent large swings in break-even inflation rates in both the euro area and the United States' (ECB *Monthly Bulletin*, April 2008: 27).

In this situation the ECB should make greater efforts to explain to the public the external factors for the recent price upsurge, emphasise its commitment to long run price stability, and back this up with a threat of quick counteraction should wage increases be such as to risk perpetuating the higher rate of consumer price inflation ('second-round effects'). This would give the ECB sufficient room for target rate reductions, limiting the downturn in euro area growth. The ELNEP recommends a swift cut of 50 basis points. The earlier measures are taken, the more effective they are likely to be: once expectations deteriorate, more substantial interest-rate cuts would be necessary to stabilise the real economy. Given the concerns about its reputation, the ECB will prefer to wait for inflation rates to show a declining trend, supporting its explanation that external price shocks will run out, before cutting. However, especially if price upsurges take longer to expire than forecast, this would overly delay the needed interest rate reduction, unnecessarily sacrificing growth and increasing the risk of a more serious downturn.

Indeed, the ELNEP predicts that the ECB will wait until the third quarter for its first target rate reduction, and then only reduce rates slowly. As the ELNEP simulation above strongly suggests, given the lags before monetary policy affects the economy, this squanders euro area growth and employment without any tangible gain in terms of price stability.

Exchange rate interventions to lower the appreciation of the euro could be thought of as an additional alleviation for the euro area economy. Yet, they would likely have limited effect, as the ECB would have to conduct those interventions in isolation at best, if not in opposition to the desires of other central banks. The depreciation of the US-dollar is a consequence of the dramatic target-rate reductions by the Fed. While they put the euro under pressure, the measures taken by the Fed are in the US interest and understandable. The exchange rate effect would be less severe if Asian countries had allowed their currencies to appreciate more. But those countries do not only have an interest in impeding a stronger appreciation, they also hold large amounts of US-dollar reserves. If the ECB were to announce an exchange rate intervention, they might be tempted to exchange their dollar holdings for euros, jeopardising the ECB's interventions. Therefore, the ECB should rather focus on interest rate reductions. That would not only support the euro area economy, but also soften the appreciation of the euro. Faster demand growth in Europe would also be conducive to resolving global economic imbalances.

Time for fiscal stimulus has not (yet) come – provided monetary policy plays its part

The state of public finances has improved significantly in most European countries in the years 2006 and 2007. Budget deficits have shrunk, and some countries are running healthy surpluses. The average deficit of the countries of the euro area was 2.5 percent of GDP in 2005, and that of the EU27 was 2.4

percent. For the countries of the euro area this figure decreased to 0.6 percent in 2007, which implies an improvement of 1.9 percentage points in the average budgetary balance in the two years (Table 5). The biggest improvement took place in Germany, where a deficit of 3.4 percent in 2005 was completely eliminated. Large improvements were also recorded in Italy, Greece and Portugal. In 2005 these were the countries which violated the Stability and Growth Pact with their excessive deficits. At the same time, those countries which were in surplus in 2005 were able to maintain or even increase their surpluses. That group consists of Ireland, Spain, and the Nordic member countries – Denmark, Finland and Sweden. The UK and France were exceptions to the general improvement.

Better fiscal balances together with faster economic growth helped most countries to achieve lower levels of public debt as a share of GDP. The average debt ratio of the euro area countries decreased from 70.1 percent in 2005 to 66.3 percent in 2007. For all EU countries the corresponding figures are 62.6 and 58.7 percent, respectively. Due to the expected damper on European growth in 2008, the past improvements of fiscal balances will stop. However, the average deficits will remain low, and the debt-to-GDP ratios continue to fall slightly.

The outbreak of the so-called sub-prime crisis in the autumn of 2007 has increased the risk of slackening growth. It is very likely that macroeconomic policy is needed not only in the USA but also in Europe in order to maintain economic growth and financial stability. The increases in house prices and indebtedness experienced in many European countries in recent years

make them vulnerable to financial risks, and especially to falling asset prices. What then would be an optimal policy response?


French fiscal policy: old constraints under a new President

The predicted cyclical slowdown will exacerbate fiscal constraints in France. The 2008 budget had been established, under the new Sarkozy Presidency, on the basis of 2.25% economic growth and was already scarcely compatible with commitments to France's European partners to cut the budget deficit. With growth expected to be around 1.7%, the deficit may be pushed back up to near the 3% Maastricht ceiling, weakening France's position as it assumes the EU presidency in the second half of the year. This has re-opened debate on the expansionary fiscal package of €14 bn (0.7% of GDP) for 2008. Around half of this is linked to tax cuts, mainly for high-earners: in the current context this seems all the less justifiable, exacerbating the deficit without necessarily boosting consumption. The other half consists of incentives to extend working time ('working more to earn more'). But by encouraging employers to extend hours rather than recruit additional workers, any gain in purchasing power will be offset by weak employment growth. Against this background the government has announced a series of measures that, while it has refused to describe them as austerity measures, amount to a freeze on public spending, which is the opposite of what is required. The concern is that the overall effect of these measures will be to increase deficits without significantly bolstering demand.

Table 5

Fiscal balances in the euro area						
% of GDP, 2002-2008						
	2004	2005	2006	2007	2008	2009
Austria	-3.7	-1.5	-1.5	-0.5	-0.7	-0.7
Belgium	0.0	-2.3	0.3	-0.2	-0.4	-0.5
Finland	2.4	2.9	4.1	5.3	4.4	4.0
France	-3.6	-2.9	-2.4	-2.7	-2.8	-2.5
Germany	-3.8	-3.4	-1.6	0.0	-0.3	0.0
Greece	-7.4	-5.1	-2.6	-2.8	-1.6	-2.0
Ireland	1.4	1.6	3.0	0.3	-0.9	-1.0
Italy	-3.5	-4.2	-3.4	-1.9	-1.8	-1.6
Luxemburg	-1.2	-0.1	1.3	2.9	1.0	1.2
Netherlands	-1.7	-0.3	0.5	0.4	1.1	1.4
Portugal	-3.4	-6.1	-3.9	-2.6	-2.6	-2.4
Spain	-0.3	1.0	1.8	2.2	0.8	-0.1
Slovenia	-2.3	-1.5	-0.1	-0.7	-0.1	-
Euro area	-2.9	-2.5	-1.3	-0.6	-0.9	-0.8
Denmark	1.9	5.0	4.8	4.4	3.8	3.1
Sweden	0.8	2.2	2.3	3.5	2.7	2.6

Source: Eurostat; 2007 Elnep estimate; 2008 and 2009 Elnep forecast.



Dominique Strauss-Kahn, the Managing Director of the IMF, in January 2008 made the case for a targeted fiscal boost in order to prevent negative repercussions from the financial crisis to world growth. He explicitly focused on countries that had gained space for discretionary policy by exhibiting low debt levels and low budget deficits or even surpluses. He also addressed Europe's usually slow recovery after negative shocks. The question therefore is whether the euro area countries should engage in such a kind of pre-emptive fiscal stimulus, considering their improved fiscal balances.

In fact, most EU countries who do have the space for fiscal stimuli do not seem to need it at the moment like for example Finland, and the Netherlands. Others have just managed to meet the Maastricht criteria (e.g.

France, Greece, and Portugal) or have high debt (Italy, Belgium) and should be cautious about discretionary expansionary measures. An obvious exception is Spain, where budget surpluses of the past could be used to smooth the necessary adjustment process regarding the housing market slowdown, which promises to be severe in that country; Ireland also seems to fit this pattern. But for all other euro area countries, the best thing to do at the moment would be to let automatic stabilisers work, assuming monetary policy is operating a 'first line of defence'.

The crisis and the related risks are primarily financial. The risks are related to over-indebtedness, uncertainty, and to the risk of falling asset prices – not only in the US, but also in many European countries. Together with falling asset prices, the high level of

indebtedness could create a vicious circle of debt deflation, or a process where lower prices reduce net wealth and increase the real burden of debt. With that in mind, fiscal policy is not as obvious a tool in preventing such a crisis as is monetary policy. The costs of debt service as well as the determination of asset prices are primarily affected by interest rates, which are set by the central banks. In the USA the Federal Reserve Board has already cut its federal funds rate by more than half since the outbreak of the sub-prime crisis in August 2007. So far the ECB has not done anything to its base rates while the Euribor rates set by the interbank markets have risen. As indicated in the previous section, the ELNEP recommends an immediate lowering of interest rates.

If the ECB starts cutting interest rates, then the European fiscal policy should be more or less neutral. That is important in order to avoid excessive stimulus. However, it is reasonable to hope that fiscal policy could help to ease the pain by decreasing inflationary pressures. This is certainly not the time for inflationary increases in indirect taxation, and because of the healthy fiscal balances, there is not much need for such measures either. Likewise, fiscal authorities should abstain from raising administrative prices. If associated with cuts in direct taxes, such measures also artificially raise competitiveness at the expense of European trading partners.

However, if the ECB decides to keep interest rates unchanged and to stay focused only on inflation busting, it is likely that finally it will be the national budgets which will bear the burden of the consequences of an overvalued exchange rate and financial

distress caused by falling asset prices. In that case the fiscal costs would be high, and the national budgets risk returning to the large deficits typical of the 1990s. If the monetary accommodation is delayed too much, asset prices may fall and create new problems both to lenders and borrowers. In that case the indebted households would react by increasing their private saving and reducing consumption, which would additionally hamper growth. These consequences would definitely call for a fiscal boost, although this would be a second best way to address the looming problems.

If the financial crisis should affect the real economy more than expected in the ELNEP forecast, slackening growth and considerably increasing unemployment, an expansive fiscal policy in the form of public investments could supplement the suggested expansionary monetary policy stance. If euro area member states reorganised their expenditures towards increasing the share of public investment (above all in education, infrastructure, research and development), this could further expand the growth potential of the euro area.

Periods of slow growth are typically periods when public revenues fall and expenditures grow, creating widening deficits. That would be made even worse if the slow-down would spark a US-type banking crisis. Experiences from the Nordic banking crisis in the early 1990s show that the only way to solve serious financial crises is that the states cover the losses of the financial institutions. That can be costly. In Finland, Norway and Sweden the states took over losses representing 6-8 percent of GDP. That was also the amount by which the public debt was increased. Yet, facing the alternative of

a breakdown of the financial system, these costs are negligible; see the section below on the policy implications of the financial crisis.

Wage policy: nominal wage anchor is holding despite higher inflation

The combination of falling unemployment and higher profits is a typical driver of higher nominal wages. Yet, in recent years, neither of these components has led to a substantial upward drift in the euro area. Now, with unemployment at its lowest level for many years and also substantially higher consumer price inflation (most recently 3.6 percent), is the nominal wage anchor about to give way? Are such concerns valid reasons for the ECB to refrain from taking action to limit the economic slowdown?

With unemployment at 7.1 percent the number of (manufacturing) firms reporting a lack of skilled labour has unsurprisingly risen to 7.5 percent; yet this is substantially lower than the high point reached in 2001 (9.3 percent, see the separate labour market report for details). Eurostat quarterly vacancy data also point to some labour market tightening, but having risen from around 1.8 percent in 2005 it stabilised at 2.3 percent during 2007 with no further rising trend apparent.

Still ELNEP forecasts gross nominal wages to increase by slightly less than 4 percent in 2008, easing back somewhat to around 3.5 percent in 2009. This implies unit labour cost growth – the decisive indicator for inflation and competitiveness – briefly

touching 2 percent in 2008 before declining to 1.8 percent in 2009. While this marks a slight increase from 1.5 percent in 2007, it is still compatible with maintaining domestic price stability as defined by the ECB. Given current price inflation of 3.6 percent, gradually expected to decline over the coming months, this implies very sluggish real wage growth for euro area workers. The slightly faster pace of nominal wage growth will almost entirely be wiped out by the faster rate of price increases. Continuing a longer-run trend, real unit labour costs will once again be negative, and the division of national income can be expected to shift further in favour of ‘profits’ at the expense of ‘wages’.

In sum, the euro area wage anchor is still holding, and this fact should be recognised when setting other policy parameters, especially monetary policy.

Wages are set at national level and it is important to look at developments in the different countries. Wages in most European countries are set primarily by collective agreements covering in some cases substantial groups of workers. Moreover, wages are set in such agreements for a specified period in advance. This makes collectively agreed wages – in principle – one economic variable that can be estimated directly in advance. These estimates can then be cross-checked against the forecasts produced by econometric models that derive wage growth on the basis of equations linking it to variables such as employment and productivity. However, collective agreements have become increasingly complex and difficult to interpret, particularly at the international level (box).

The ELNEP has sought to collate up-to-date information from a number of sources on recent collective agreements in the euro area in order to estimate the likely trajectory of wages during 2008 and 2009². In view of the major difficulties in interpreting the implications of complex collective agreements for actual wage outcomes on a calendar year basis, the following table provides both a qualitative assessment and a tentative forecast for each country.

To some extent the very rapid run-up in prices constitutes ‘surprise inflation’ that was not, and could not have been, foreseen in the collective agreements. This is one major reason why the price increases have not manifested themselves in appreciably faster wage growth. As discussed more broadly in the separate labour market chapter, the changed wage-setting behaviour compared with earlier times, when tightening labour markets and price rises would have triggered faster wage inflation, may well reflect the opening up of national labour markets and, particularly, the enlargement of the European Union.

This overview gives support to the view that the nominal wage anchor in Europe can be expected to hold. Collectively agreed wage increases of around 3 percent in the current year, even allowing for some positive wage drift, are below what the ELNEP recommends as a medium-term pay norm: the sum of the inflation target of the ECB (1.9 percent) and medium-run labour productivity growth (around 1.5 percent in the euro area). Given that inflation is considerably above target, wage-earners are, collectively, avoiding the pass-through of

higher prices to wages and taking the increased cost of living ‘on the chin’. It is therefore vital that other policymakers, and particularly the ECB, also remain focussed on the medium run and avoid factoring higher imported prices into their policy decisions.

² This assessment is based on an evaluation of the following sources: national assessments by ELNEP members, national trade union confederations, the ETUI/AIAS monthly Collective bargaining newsletter, the monthly Industrial Relations in Europe Newsletter (Watson Wyatt), ISTAT, the European Metalworkers’ Federation EUCOB@N REPORT 2007 (unpublished), ETUI research for the European Chemical Workers’ Federation.

ELNEP member country	2008	2009	Notes
Austria	3.3	3.0	Austrian collective agreements mostly for one year were signed at the end of 2007 covering the calendar year 2008. Outcomes were rather concentrated between 3.2 and 3.5%, an acceleration on the previous year, but less than the increase in inflation. High coverage of agreements implies confidence in the reliability of the forecast for 2008.
Denmark	4.2	4.2	The numbers are part of an on-going three-year national agreement with a very high coverage level. Figures include an estimate by LO-DK for wage drift. Collectively agreed outcomes are expected to be somewhat lower both in 2008 and 2009.
Finland	4.4	3.7	The figures are, as in DK, part of a longer-run agreement. Some public-sector settlements have been higher, but this represents compensation for previous settlements lagging behind the public sector.
France (gross wages)	3.4	3.3	Apart from the (large) minimum wage sector, collective bargaining in France is rather fragmented. The figures given correspond to a slowing down of real wage growth in 2008. The national minimum wage (SMIC) does not benefit any longer from increases due to the 35 hour-week law. It rose by 2.1 % on July 1st, 2007 and, as the inflation exceeded 2% from that time, it will augment automatically by 2.3 % on May 1st, 2008.
Germany	2.2	2.5	Actual collectively agreed wage increases in Germany are expected to be only slightly higher than the (low) rates achieved in recent years. This is despite a number of agreements that have made the headlines implying a marked acceleration of wage growth. In some cases these agreements were simply for marginal groups (the GdL train drivers) or represent the total increase for the life of a multi-year agreement. In others most of the effective wage rise is not felt until 2009. Less obviously, this year has seen a faster increase in the rate of 'permanent' wage increases, whereas before these had been lower but accompanied by one-off payments. The effect of not repeating the one-off payment this year is to reduce the total value of the agreement in 2008.

ELNEP member country	2008	2009	Notes
Italy	2.9	2.5	Italy is similar to Germany in that headline increases have been above 3% in agreements reached in the early part of this year (e.g. metalworking, banking). Still, due to the high number of workers waiting for agreement renewals (over 55% in the last six months), ISTAT's monthly index sees average increases fluctuating between 2 and 3% during recent months.
NL	3.25	3.75	This figures are based on the assessment of the Central Planning Bureau and are in line with the overall orientation set by the FNV organisation for the current year.
Spain	3.0	2.3	In Spain the interpretation of collective agreements is particularly tricky as most agreements contain complex formulae to make adjustments for prices. While not amounting to full indexation this will tend to pull up the price component of the wage outcomes. Given Spain's loss of international competitiveness and its particular problems in housing etc., it seems likely that this will be offset by concessions regarding the productivity component of wage increases.
Sweden	3.5	3.5	As in FI and DK, Sweden is in the middle of a three-year bargaining round ensuring stable wage growth into 2008 and 2009.
Non-ELNEP-countries	3-5%		Some important recent agreements in non-ELNEP countries include a 5.7% increase in the minimum wage in Portugal, although this is for a small proportion of workers, and the average increase is running at 3-3.5%; a 5% rise foreseen in the Irish social partner agreement is due for renegotiation with expectations of a gentle deceleration; the UK national minimum wage recently rose by 3.8%. As in Spain, Belgian agreements are complicated by the inclusion of price compensation mechanisms, although these are explicitly designed to exclude volatile price components such as energy. Moreover the framework for Belgian wage increases is tied by law to those of close trading partners.
ELNEP-countries	2.9	2.8	Weighted average (using employment weights)
Euro area	3.0	2.9	Weighted average (using employment weights)

Laval, Viking, Rüffert: Collective bargaining in Europe under the shadow of ECJ decisions

In recent months the European Court of Justice has issued judgements in three landmark cases that all related to the same basic issue: the relationship between the fundamental freedoms of companies to establish themselves elsewhere or offer services across the EU, and the right of governments and trade unions to insist on respect for national collective agreements and labour standards. The specific legal debates are extremely complex: the Laval and Viking cases ruled on the legitimacy of action by a national and international trade union, respectively, to take industrial action in order to pressure employers based abroad (Laval) or seeking effectively to ‘relocate’ abroad (Viking) to respect existing national collective bargaining practices. The Rüffert ruling examined whether regional governments, in public calls for tender, are permitted to insist that also foreign contractors respect locally applicable collective agreements.

The essence of the judgements³ is that the economic freedoms to establish or offer services across borders are seen as ‘fundamental’ freedoms. While it is a fundamental right to take industrial action, in line with national laws, and to make non-discriminatory stipulations in public calls for tender, these have to meet a series of conditions if they are to be considered legal under EU law. Among other things the collective action has to be justified and

‘proportional’, and the collective standards invoked must have legal or quasi-legal binding force on all market participants. The latter requirement is problematic especially for those Nordic countries that have traditionally relied on collective agreements (rather than laws) to set labour market standards and to the many countries with a complex mix of legal and collectively agreed standards. These issues have to be decided case by case by national courts, with the risk that collective action and government rules can be retrospectively declared illegal.

The immediate effect on workers’ organisations in high-wage countries is to raise the uncertainty about and potential costs of industrial action wherever there is (potentially) a European dimension; with growing cross-border trade, this will become an increasing constraint. By itself, this will weaken the bargaining position of organised labour in high-wage countries. On top of this come European-wide effects. The rulings imply the risk that domestic companies in high-wage countries will systematically be ‘discriminated against’ (Inländerdiskriminierung). This is because domestic firms will be obliged to adhere to domestic regulations and (more generous) collective agreements, whereas foreign competitors will not; they will merely have to respect national minima. This creates a huge incentive for companies to subcontract work to subsidiaries that are, on paper at least, located in low-cost EU countries. This can be expected to put downwards adjustment pressure on collectively agreed standards and the institutions of collective regulation; the latter will probably raise pressure for a ‘juridification’ of national industrial

³ Of course this does not nearly do justice to the complexity of the cases. For a full assessment see: <http://www.etuc.org/r/846>

relations systems, at the same time as the flexibility of voluntary agreements between the social partners is being touted by European policymakers as 'best practice' to regulate labour markets.

The integration of European markets is a welcome development that can promote shared rising living standards. However, these legal decisions raise the prospect of a 'race to the bottom' that, not least, will have the effect of turning Europe's workers against European integration.

While wage increases seem to be well-anchored on the euro area level, it is also important for wage setting on the national level to be oriented towards the recommended pay norm in the medium term: If wages increase by less than the ECB's target rate plus annual labour productivity growth in the medium-run in the country concerned, internal demand suffers, as has long been the case in Germany. If wage growth exceeds this guideline, national competitiveness is lost and – to the extent that these increases are reflected on euro area inflation rates – the ECB will hike interest rate hikes, weakening growth and employment opportunities across the currency area.

There are some tentative signs also of a correction of the intra-EMU imbalances that had been building up due to persistent differences in the rate of growth of nominal unit labour costs (see the labour market chapter for a discussion). In this context the (slight) acceleration in Germany and the more significant rise in Austria are to be welcomed; indeed, a faster acceleration in Germany would be advisable in terms of

intra-EMU imbalances. Meanwhile wages are decelerating in Italy and Spain. However, unless productivity growth accelerates in these countries, unit labour cost growth will once again outpace the euro area average, making it hard to address competitiveness concerns in those countries.

Difficulties of assessing collective wage agreements

The phrase 'the devil is in the detail' might have been coined for collective agreements, which in many countries have become increasingly complex. Some of the methodological problems in arriving at a figure for annual collectively bargaining wage increases include the following:

- Changes in working hours
- Important non-wage elements such as training allowances, pension contributions, etc.
- Lump-sum and one-off payments that drop out of the calculations the following year
- Back-dated payments
- Differential increases for certain categories of workers without corresponding employment data.

The ETUC and a number of European sectoral trade union bodies, such as the EMF, EPSU and the EMCEF, are seeking to improve the monitoring of collective agreements. Whereas some useful forward-looking indicators and surveys exist at national level, the time needed to analyse the complex agreements in all the European languages and process the findings means, that where comprehensive and reliable

statistical information is available for the euro area or EU as a whole, it is largely 'historical' data, and despite the forward-looking nature of collective agreements, of limited use for economic forecasting purposes. European policymakers should consider making additional resources available for this important work.

Resolving the financial market crisis

The present economic situation is overshadowed by a crisis on financial markets that threatens the continuation of the still dynamic business cycle. That would mean that, as in 2000/01, the end of an upturn would be primarily caused by severe distortions originating in financial markets (rather than by supposed rigidities on labour or other markets). In order to acknowledge present risks and to avoid future distortions it is necessary to understand the origins and the nature of the present crisis.

There are several roots to consider. As the OECD (2008) puts it: 'At the core of the US sub-prime mortgage crisis, and its global repercussions, lies financial innovation, transferring mortgage risk through securitisation from mortgage lenders' balance sheets to other parts of the financial system and to other investors globally. Years of low interest rates with easy financing, innovative, non-traditional mortgage products and risk transfer through mortgage securitisation generated a rising volume of loans that had been extended increasingly to sub-prime borrowers.'⁴ To create such a situation several preconditions had to be in place.

First of all there was an abundance of liquidity searching for investment. Frequently the central banks, especially the US Federal Reserve, are blamed for having kept interest rates too low for too long. But one has to keep in mind that the very same low interest rates allowed for a swift recovery from a severe recession and kept the real economy on a relatively expansionary path. Moreover, the Fed had started in 2004, well ahead of the financial market crisis, to tighten its course steadily, increasing interest rates no less than 17 times from 1 percent to 5 1/4 percent, a course that was well signalled to markets. Former Fed Chairman Greenspan (2008) defends himself by asserting that the massive credit expansion did not show up in the figures until 2005 when the tightening process of the Fed had already begun.⁵ Given these considerations it does not seem appropriate to blame the Fed or other central banks that – with the notable exception of the Bank of Japan – kept interest rates even higher throughout the trough.

A question rarely asked is why the growing liquidity was invested in financial investments instead of into real economy assets in the first place. Obviously profit expectations for financial investments were perceived as being higher than those for real economy investments. Of course in the short run and in a single country there can be an imbalance between actual or expected returns on real and financial investments,

⁴ OECD (2008): The Recent Financial Market Turmoil, Contagion, Risks and Policy Responses: How well are we weathering the storm?, DAF/CMF no.9, page 17.

⁵ Greenspan, Alan (2008): A response to my critics, FT.com; download (08-04-2008): <http://blogs.ft.com/wolfforum/2008/04/alan-greenspan-a-response-to-my-critics>.

but this perception must be wrong in the longer run, at least from a global perspective. This is so for the simple reason that, in the end, any financial investment is based on a real economy investment.

At its most simple, three parties are involved in a classical investment process: somebody who owns capital, a financial institution and a firm or investor. The money is given by the capital owner, in expectation of a financial profit, to the financial institution. This institution will pass the money on to a firm that needs it to finance some real economy investment, also in expectation of some profit. This chain of money is in the end based on the profitability of the real investment undertaken by the firm. Only then will the financial institution receive its money back with profit and channel this back to the original capital owner with the expected value added.

Beyond doubt, the real world is much more complex than outlined here. Nevertheless even if there are a lot of capital owners and firms, and a lot of steps in the financial intermediation process involving more and more complex instruments, the basic relations between them remain the same as described above. In such a model the banking, or more generally the financial sector performs the useful, indeed crucial, social function of matching the needs of savers and borrowers/investors and allocating capital to real investments that create employment opportunities and the capital stock with which to produce more and/or higher quality goods and services.

The profits of the real economy activity have to be high enough to cover the financial intermediation costs. On the one hand also

credit has to be profitable, otherwise a bank or any other financial institution would not supply it. If it is more profitable (for a given risk) to invest directly in real economy activity than to engage on capital markets, the former should expand more rapidly than the latter leading in due time to a decline of profits in the real sector, narrowing the gap to financial investments. The reverse applies, too. If investing in the real economy is less profitable than investments in financial products, one would observe a stronger expansion of the latter. This is not sustainable, however. Financial investors will increasingly meet difficulties in finding investment opportunities and more and more have to compromise on profitability and offer funds to companies on more advantageous terms for the latter. In the end it leads to a decline of profitability in the financial sector (and/or wider profit margins on real investments in the non-financial sector), narrowing the gap to real economy investment.

There is a lot of evidence that the latter situation has characterised developments during recent years. Trade volumes on financial markets have utterly exploded while the real economy was growing strongly but far less buoyantly. Even non-financial firms were increasingly diverting resources from the real economy to the financial sphere.⁶ As part of this trend there was considerable innovation in the financial markets industry, particularly to deal with credit risk. New financial instruments were created partly enabled by technological progress (the ICT revolution), but also in the

⁶ Hein, Eckhard /van Treeck, Till (2008): Finanzmarktorientierung – ein Wachstumshindernis?, IMK Report Nr. 26, Januar, Düsseldorf.

wake of an extended and far-reaching political drive to liberalise the financial sector. Particularly in the English-speaking countries, but also in a number of Continental European countries, restrictions on certain activities that had previously constrained the actions of financial sector institutions were lifted.

One of the most striking innovations is the vast expansion of risk pooling by combining totally different sorts of risks, a process known as securitisation. This is why sub-prime credits – housing loans made by mortgaged brokers to high-risk individuals in the US – made their way through the financial system. There is nothing wrong with securitisation in principle, as long as there are no dangerous side effects. These are not to be expected in models based on the idea of ‘perfect information’, but in the real world, as we know, such side-effects can hit with a vengeance.

From the viewpoint of a single financial institution securitisation has positive effects, since pooled risks diminish the probability of default. From a macroeconomic point of view the story is different. By spreading risks all over the globe, the risk of contagion has increased. If there are defaults, like in the US sub-prime sector, that would have led to a local crisis in the US in earlier times, now the global financial system is affected. Furthermore, propagation is enhanced by diminished transparency that is caused by the very same pooling of risks. Investors and even rating agencies frequently simply do not know the kind of risks involved with their assets. Worse, the financial system is riddled with information asymmetries. This enables unscrupulous lenders to provide credit knowing that it will never be paid:

responsibility for credit default is sold on to those who do not have the required information to monitor the underlying loans and who place their faith naively in rating agencies.

For as long as markets are optimistic, investors nevertheless will continue to buy assets. But as soon as default emerges for some risks, trust vanishes and all kinds of assets even those originally not affected by defaults will suffer. Their prices dive triggering mounting waves of write-offs by financial institutions. The falling value of assets has knock-on effects on willingness to lend.

This is exactly the present situation of the financial system. As the risk awareness for these new financial products had been inadequately low, furthered by their complexity, so had been requested returns (risk premia): even relatively small default numbers of mortgages in the US incurred higher losses on the financial products.

Another crisis-enhancing factor is leverage: using borrowed money to make financial or real investments. While creating liquidity for additional investments in good times and thus promoting growth during these periods, it also pushes up the price of assets, be they financial (such as stock values) or real ones (such as house prices). Moreover, leverage works both ways. The mechanisms go into reverse during bad times. When interest rates are rising and leverage becomes more costly, doubts about the underlying returns can suddenly surface. There is shrinking trust in assets pledged as collateral. A leveraged asset is much more endangered than a non-leveraged one, both because of credit costs and the link to existing asset

prices. Then default becomes more likely. That means that during bad times a highly leveraged system can be dangerously unstable. Here again, what was widely thought to be an innovation in financial market technology shows a dangerous, crisis-enhancing feature.

Recent financial market innovations made credits cheaper in good times. These advances in credit technology together with a reduced risk awareness have led to an excessive creation of credit not supported by real economic returns. Therefore a downward correction was inevitable. Unfortunately the nature of the financial system is such that the downward adjustment will be excessive, too. Therefore a contagion of the real economy is highly likely. The willingness of financial institutions to supply different sorts of credits will fade rapidly. First indications of that can be observed in the euro area: Lending conditions have worsened already.

This raises the question of how to deal with modern developments in financial markets, now that their potential dangers have been revealed. As for every case in which the incentives for private behaviour lead to actions that impose costs on others and society at large, one needs regulation: a set of rules that promotes efficient and also socially just outcomes. These are justified in order to protect the real economy from the potentially damaging impact of financial markets and to protect financial markets themselves from excessive movements. This is not to advocate a step back to the seventies or eighties when capital market flows were still heavily regulated. Broad-based capital market access is important in making financial intermediation efficient

and in enabling willing investors to finance real investments. However, limits must be imposed on the dangerous features of financial markets. Banks and other financial institutions receive various forms of public support, from privileged access to central bank money up to and including bail-outs. It must be made clear to all actors that the price for this is acceptance of regulations designed to prevent abuse of such support.

First of all more transparency is necessary so that market participants are better able to assess their risks properly. Rating agencies in their present setting are of little help to ensure this. They have been shown to face numerous conflicts of interest. In the future they should no longer be paid by the supplier of assets but rather by the buyer. Furthermore they should be supervised by a state agency to detect any misbehaviour resulting from a conflict of interests. Furthermore there should be rules on how to describe the contents of assets properly or a standardisation of these products.

Secondly, in order to diminish the incentive to sell rather risky assets, and encourage careful lending practices, the first creditor should be obliged to keep a certain stake in the underlying assets, e.g. 10 percent of the volume. Thirdly, capital adequacy (minimum reserve) requirements need to be rethought in order to limit leveraging to levels that do not generate systemic risks or the likelihood of defaults for which the taxpayer will have to assume the burden. This will limit the 'financial accelerator', in both directions, promoting economic stability. Fourthly, there is a need for an EU banking authority that supervises banking behaviour in the EU and is responsible to enforce regulations. In this way financial institutions

will be prevented from evading national regulations by moving risky assets into branches located in a country with more lenient rules. Therefore it would be most appropriate to settle this authority at EU level in order to include the very important financial trading centre London as well as many smaller countries to make such evasion more difficult. In order to achieve these aims it will be necessary to amend the Basle II agreement⁷ in appropriate ways, and ensure that it is applied to an even wider range of countries. Those (usually small) countries that see their ‘comparative advantage’ in promoting avoidance of taxation and regulation by offering largely unregulated jurisdictions to financial firms and wealthy individuals need to be pressured into accepting common minimum standards.

In the current situation, the most important short-term aim is to restore the functioning of financial markets. Yet, the means chosen to achieve this aim should avoid socialising the losses of institutions that have a history of successfully privatising their gains. Shareholders must accept losses. Should in the longer run the recommended regulations become effective, financial markets should be more stable than they are right now. This would enlarge central banks’ leeway for monetary policy, because they would not have to keep such a keen eye on financial market bubbles, instead – as is their real duty – on aggregate inflation and stabilising real growth.

⁷ Basel II is an effort by international banking supervisors to update the original international bank capital accord (Basel I, in effect since 1988), developed by the Basel Committee on Banking Supervision. The revised accord aims to improve the consistency of capital regulations internationally, make regulatory capital more risk sensitive, and promote enhanced risk-management practices among large, internationally active banking organisations.

More and better jobs? – Labour market developments in the euro area since 1999

Companion report to the ELNEP economic forecast
and policy recommendations, May 2008

Introduction

Irrespective of the increased attention recently focussed on financial markets, and the claims of some that work has lost its central importance in people's lives, of all the markets in a market economy it is the state of the labour market that is decisive for the economic and also social well-being of the vast majority of Europe's citizens. All but a small minority of households depend for their living standards on one or more members holding down a decent job. Alongside wage and salary income, the quality of work and the ability to reconcile paid employment with other responsibilities and life-interests are key determinants of well-being.

At the same time the labour market determines other important economic outcomes. Rising labour productivity is a key driver of economic growth; wage increases and employment growth drive consumption and also exert an important influence on the state of government budgets; the wage-productivity nexus is vital both for competitiveness and helping to ensure price stability.

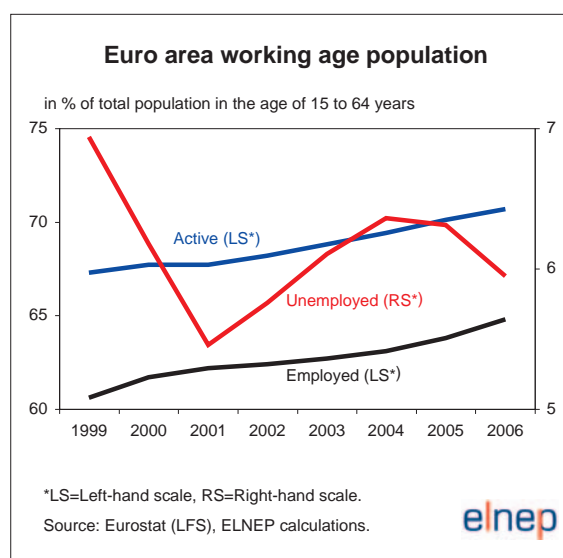
For these reasons the ELNEP report, unlike other economic forecasts, devotes a separate chapter to labour market developments. At the end of this year we will be able to look back on ten years of European Monetary Union. With this in mind we provide an

overview of key labour market developments since the start of EMU in 1999.

Employment and unemployment

Raising the proportion of the working-age population in employment is a key goal of the European Union's Lisbon Strategy, which set employment-rate targets – for the whole European Union – of 70%, 60% and 50% for the total employment rate, women and older workers (55-64) respectively. They were to be reached by 2010. In the euro area the starting levels in 1999 were 61%, 51% and 34% respectively. Clearly, achieving the targets means that the number of people in

Figure 1

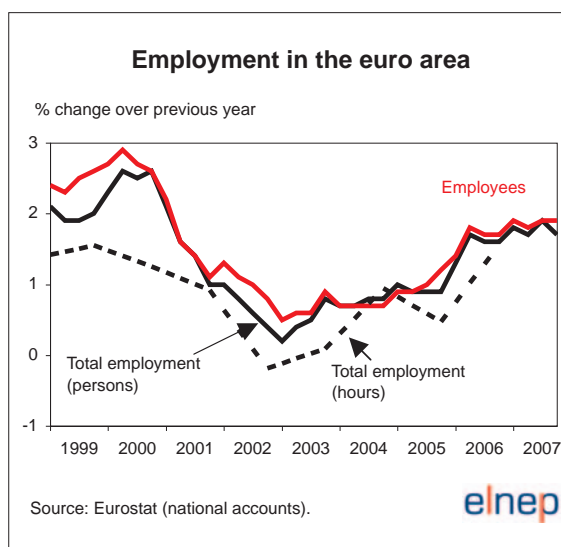


work has to grow faster than the relevant population (the working-age population for the first two and the population aged 55-64 for older workers).

Since 1999 the working-age population has increased only very slowly (an average of 0.3% p.a.). By contrast total employment has risen at an average rate of 1.3% a year. Some 13 million jobs were added over the period, a 10% employment increase in terms of persons. Against the background of the sluggish growth in the working age population, this raised the employment rate from 60.6% to 64.8%. Figures 1 and 2 show the trend over time, and indicate the proximate source of the problems in achieving the overall Lisbon target: in the periods of buoyant economic growth at the start and the end of the period, employment growth was strong, at or (in 1999 and 2000) even above 2% a year. However, the four years from 2002 to 2005 were characterised by sluggish employment growth – below 1% p.a. Correspondingly, in those years there was virtually no progress in raising the employment rate. The sensitivity of employment to the business cycle is starkly brought out by the fact that the employment-rate increase in 2006 alone was substantially greater than that achieved in the years 2001-2005: it seems hard to argue that this was due to a sudden reduction in ‘labour market rigidities’. Rather this clearly reflected the long-overdue economic upturn.

It is important to note in Figure 2 the (small) differences in the growth rates of total employment and those of employees, and the (considerably larger) gaps between employment growth measured in persons and in working hours. The former is due to the secular decline in self-employment (not

Figure 2



least in agriculture) in a number of euro area countries, and also appears to be cyclically sensitive, the gap widening at the top of ‘booms’ and the bottom of ‘busts’.

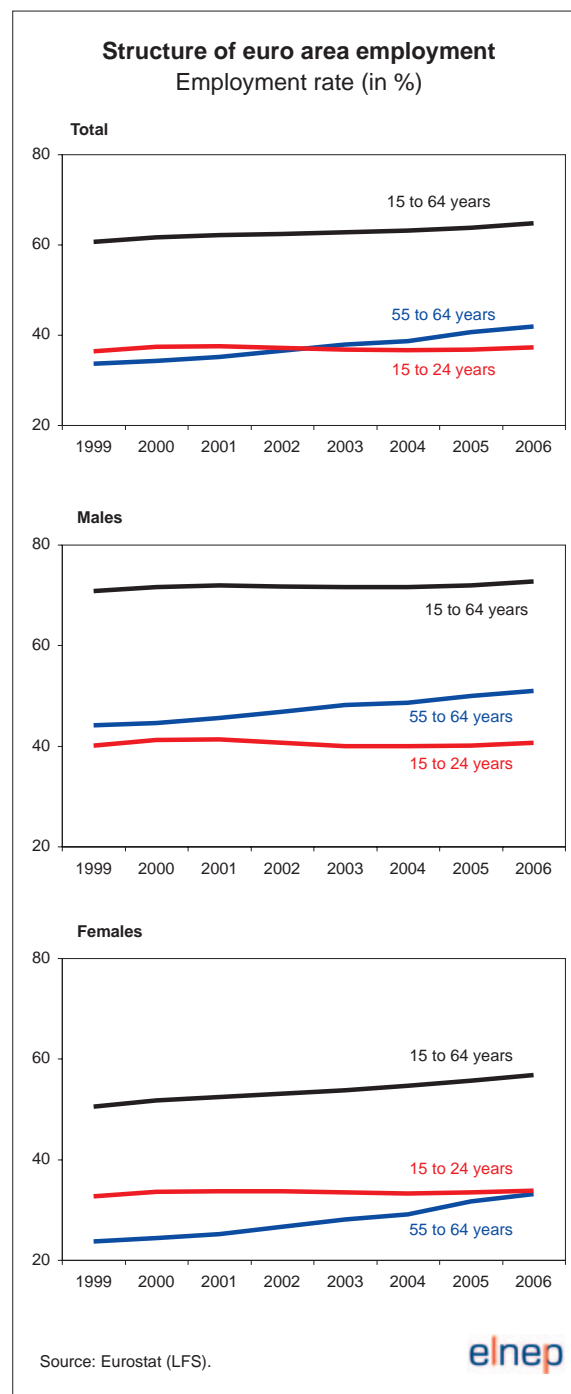
Hourly data is, in principle, more telling of the overall state of the labour market than counting ‘heads’. Unfortunately, however, they are less reliable than for employment in persons, and, a drawback especially for forecasting, they are not available as timely. The graph suggests a decline in the average hours worked per person in the euro area. This, in turn, is due to two main factors: increasing part-time employment (of which more later) and a decline in average full-time hours. Continued employment growth in Europe in the face of sluggish economic growth has been frequently remarked upon: there has even been talk of ‘growthless jobs’. While productivity growth has been weaker, a phenomenon addressed in detail below, as Figure 2 makes clear, this apparent paradox is partly due to a working-time effect: total working hours growth was zero or negative throughout 2003 and only about half the growth rate measured in persons in 2004.

Progress in raising employment rates has been much faster among women than men – of course starting from a lower base. The share of the female labour force in work (part or full time) has risen from around 51% to 57%, making attainment of the 60% target a realistic possibility, provided the renewed economic slowdown can be arrested. This development represents both demand-side factors (such as the steady expansion of service employment at the cost of male-dominated manufacturing) and supply-side changes (increased education levels and changing family structures and social attitudes, and in some cases measures providing adequate child and elderly care).

Similarly, progress has been above average in bringing elderly workers into employment, albeit from low levels (for instance compared with the US). The employment rate has risen by some 8 p.p., reflecting public policies to increase the incentives to stay in the labour market and in some cases downward pressure on pensions and the tightening of entitlement conditions to disability and other benefits. By contrast the employment rate of young workers has remained virtually constant over the period. This is the outcome of two contradictory – but both welcome – trends: young people remaining longer in education, on the one hand, and improved labour market chances (as reflected in declining youth unemployment) on the other.

Unemployment has long been considered ‘economic policy problem number one’ in Europe, and especially in the euro area. The unfavourable comparison with, especially, the US and UK has been widely seen as ‘proof’ that the ‘European Social Model’, whatever its advantages in terms of equality

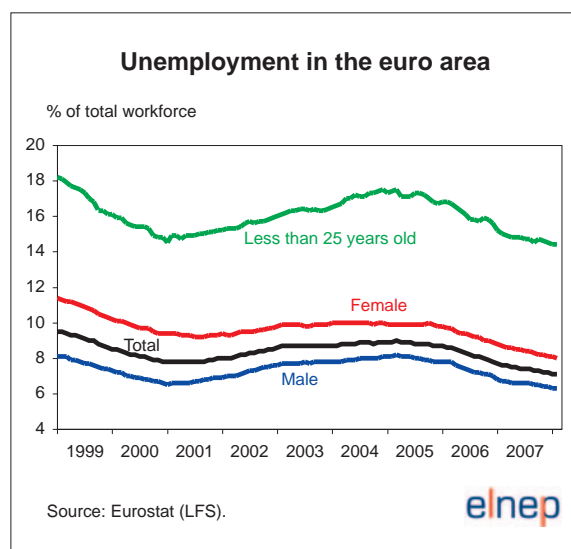
Figure 3



and other social outcomes, condemns economies to high unemployment. Although there is no official unemployment target in the Lisbon Strategy, in 1997 the EU launched the European Employment Strategy (EES) with the aim of improving

labour market performance and reducing unemployment. How has the euro area performed in terms of unemployment since 1999?

Figure 4



In absolute terms unemployment (as defined on a standardised basis by Eurostat) has been reduced by more than 1.6 million persons (or 13%) since 1999; still, in 2007 11.2 million persons were unemployed in the 13 euro area countries. Measured as a proportion of the working age population (as in Fig. 1), unemployment fell from 6.9 to 5.9%; however this was only fractionally lower than in 2001: the subsequent economic stagnation led to small but steady rises in unemployment as a share of the working age population.

Turning to the more familiar unemployment rate, i.e. the unemployed as a proportion of the labour force (the sum of employment and unemployment), it has come down by more than 2 percentage points to 7.1% in

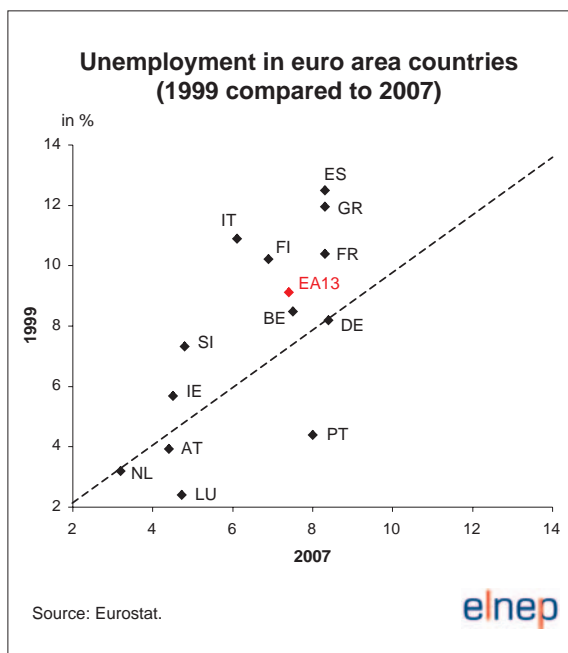
early 2008 (Fig. 4). This is the lowest figure for decades, although it remains higher than in the US and non-euro area EU15 countries. The male and female rates follow the overall trend closely. While female unemployment is consistently higher than for men, the gender unemployment gap has narrowed considerably: the male and female figures are now less than one percentage point from the total rate, and unemployment among women has declined by 3.5 percentage points, compared to 1.8 points for men.

Youth unemployment also closely follows movements in the overall trend, but at a much higher level, roughly double the overall rate, representing a key blight on euro area labour markets. It is true that the youth unemployment figures are much lower when expressed as a proportion of the overall population aged 15-24, i.e. including the high and rising number of youngsters in education. However, this indicator is also hard to interpret, as young people may remain in education or training precisely because of a lack of opportunities on the labour market.

Figure 5 clearly shows the broad-based – in geographical terms – improvement in the unemployment situation in the euro area: only Portugal suffered a substantial rise in the unemployment rate over the period¹. There was a slight up-tick in Austria and no improvement in either Germany or the Netherlands (although the latter was arguably at a situation approximating to ‘full employment’ already in 1999). The biggest reductions were achieved by those countries in which unemployment had initially been highest (Spain and Greece), with big improvements also in Italy and Finland. This

¹ The rise in Luxembourg was from an extremely low level.

Figure 5



pattern implies a marked convergence of unemployment rates across the currency zone; the rate gap closed from around 10 p.p. in 1999 to just over 5 p.p. by 2007. Some may be tempted to see this as a sign of ‘policy learning’ from good performers, as envisaged in the EES; this is open to debate. To an important extent it reflects an EMU effect: previously high-unemployment countries such as Spain and Greece benefited from a substantial fall in interest rates and consequent dynamic economic growth on joining the currency union.

The decline in unemployment has given rise to claims that the euro area is operating close to capacity or to the NAIRU (non accelerating inflation rate of unemployment), which would imply wage and thus inflationary pressure and a need for tighter demand-side policies. This issue is addressed with regard to the current situation in the wage policy section of the main report. However it is interesting to look

at the issue of labour market slack and wage trends over the life-time of the EMU.

Labour market slack, wage growth and labour costs

In fact it is not at all easy to determine the degree of labour market tightness, particularly in a heterogeneous currency area, where responsibility for labour market management, labour market policy and, not least, wage setting, remains almost solely at national level.

Figure 6

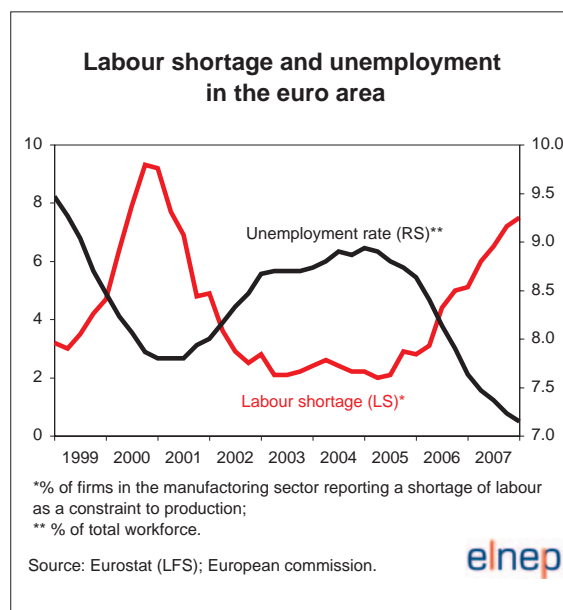


Figure 6 indicates, based on survey data, the proportion of firms reporting a shortage of skilled labour as a constraint on production. This is harmonised quarterly data. It has the drawback of applying only in the manufacturing sector, representing less than 30% of employment in the euro area. Also employers may have an incentive to ‘over-report’ such shortages in pursuit of goals

such as training subsidies or changes in restrictive regulations (although even then changes over time ought to be informative). The graph shows the expected inverse relationship between unemployment and the perceived shortage of labour. (The same data, plotted on different axes, gives a version of the so-called 'Beveridge Curve'.) Noteworthy is the sharp rise, and equally abrupt subsequent fall, in the proportion of firms facing labour constraints in the period 2000-2002, which rose from 3 to 9.3% in just six quarters.

Importantly for interpreting the current situation, unemployment is now more than half a point lower than the previous low-point, but the number of firms experiencing labour shortages has only risen to 7.5%. Unless there has been a shift in employer perceptions irrespective of actual labour supply factors, this indicates an improved supply-side responsiveness of the euro area labour market: the Beveridge Curve has shifted towards the origin, and it has flattened. There are a number of potential explanations for this. One is labour market reforms that increase pressure on the unemployed to be available for the labour market and/or policies that raise the skills, mobility and motivation of the unemployed. Another is employers' increased access to foreign labour. It is noticeable that the improved figures come after the enlargement of the EU in 2004, which facilitated the access of workers from eastern Europe to euro area labour markets; on top of this, countries such as Spain have experienced substantial inward migration from outside the EU.

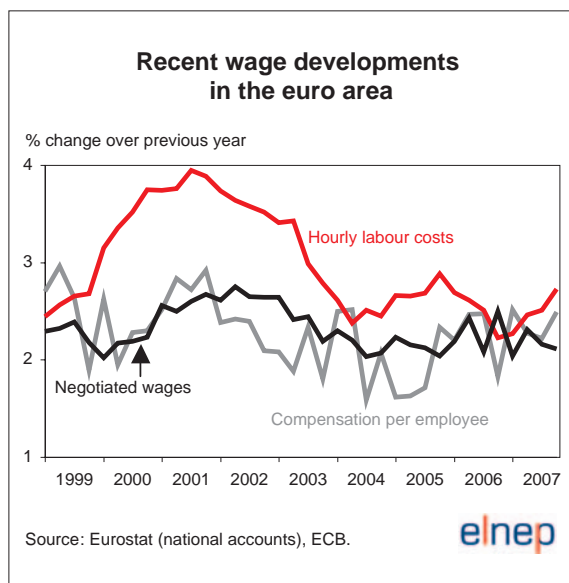
Data on job vacancies are known to be problematic even at national level, as they

can be influenced by changes in the extent to which employers report their job openings to the relevant authorities. Eurostat has a quarterly harmonised series for the EU15 expressing vacancies as a percentage of labour demand (the sum of vacancies and occupied posts). It shows the vacancy rate flat (at 1.6-1.8%) in 2003-2005, from which level it rose slightly to oscillate around 2.3% in 2007. This points to a tightening, but it is hard to evaluate its extent.

In view of such problems, it is arguably best to look directly at wage data: if labour markets are tightening, this should show up in a stronger bargaining position for labour in negotiations with employers, and thus in a faster pace of wage growth. Given that wages reflect, besides relative bargaining strength, in particular also inflation and productivity, we need to consider, alongside nominal wage growth, indicators that take these factors into account.

As regards nominal wages there are three main indicators available for the euro area on a quarterly basis: the time series are reproduced in Figure 7. 'Negotiated wages' is compiled by the ECB based on information derived from national central banks. It covers wage increases in collective agreements and thus excludes pay changes agreed at the individual level, 'voluntary' payments by employers and changes in taxes and social insurance contributions that can affect workers' take-home pay and firms' labour costs. It also misses compositional changes (e.g. rising part-time work). (Our own analysis of current collective agreements can be found in the main report in the section on wage policy). Compensation per employee is a comprehensive national accounting concept that

Figure 7



includes all payments by employers to workers; for forecasting it has the disadvantage that it is not available in a timely way.

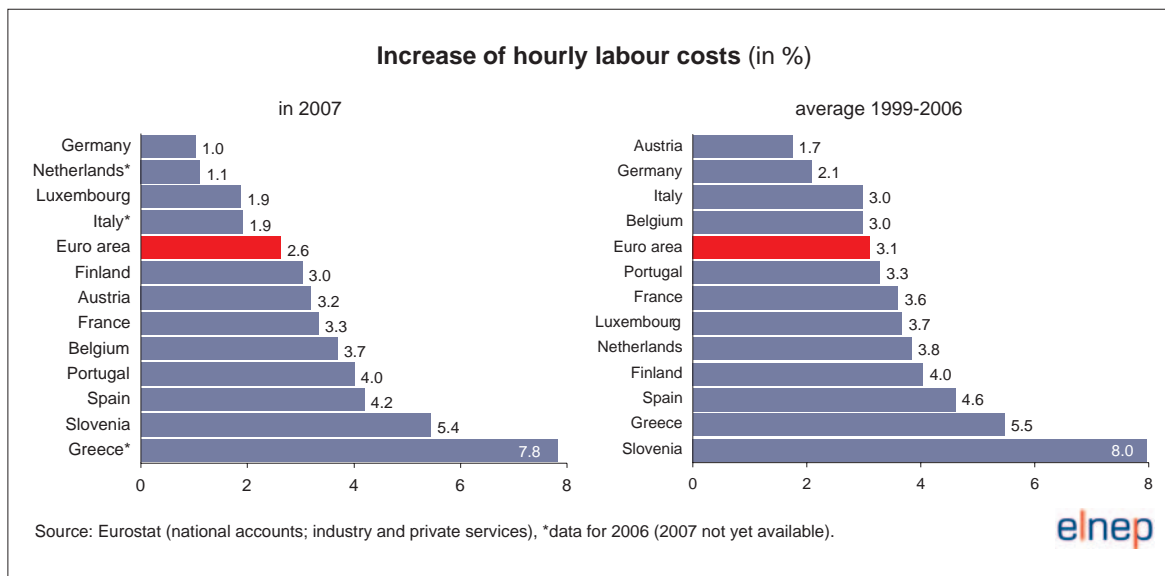
What is most striking about these two series is the way they fluctuate within a narrow band between 1.6% and 2.6% a year: in only four quarters and never since 2001 has either series exceeded an annualised rate of 2.6%. The annual average increase for both series is 2.3%. This is only slightly above the ECB's implicit inflation target of 1.9% and marginally above the average annual increase in the cost of living (HICP) at 2.1%: real wage growth in the euro area as a whole has been extremely sluggish. Moreover, the series are seemingly rather insensitive to the state of the labour market and economy. There was a somewhat delayed and muted acceleration of wages in 2001 after the last pick-up in economic activity; more recently though, the pace of wage increases has been mixed: nominal compensation fluctuated, ticking up slightly in the final quarter, while collectively agreed

wages were actually on a downward trajectory during 2007; hourly labour costs, discussed next, rose during 2007 by around 1/3 of a percentage point.

In principle the hourly labour cost measure (calculated by the ECB) is a better indication of pay trends, but has the disadvantage that hours data are based on surveys and are considered unreliable. From the perspective of labour it also has the drawback that it varies with changes in tax and contribution rates. This measure has been growing at a consistently somewhat higher rate than the other two series (average of the annualised quarterly values: 3.0%). This implies real increases in hourly gross earnings of just under 1% a year over the period as a whole, although whether this directly benefits workers in the form of higher take-home pay depends on changes in taxation and social welfare systems. While such changes may partly explain the gap with the other two series, the main reason for the difference is the increase in part-time work (see below).

Be that as it may, an interesting feature is a somewhat greater cyclicity of the hourly-cost data: at the end of the 2000/01 boom hourly labour costs briefly touched an annualised growth rate of 3.9%. Similarly to the discussion of labour market constraints above, it is noteworthy that, despite the marked fall in unemployment, the rate of growth of hourly labour costs is markedly lower than in the previous upturn. This analysis confirms that, for whatever reason, the euro area is clearly able to reduce unemployment to lower levels than before without tighter labour markets igniting wage pressure.

Figure 8



In conclusion nominal wage growth in the euro area has been subdued and seemingly less responsive to the state of the labour market. Along with the Beveridge curve, the Phillips Curve – relating unemployment to wage inflation – also appears to have flattened markedly.

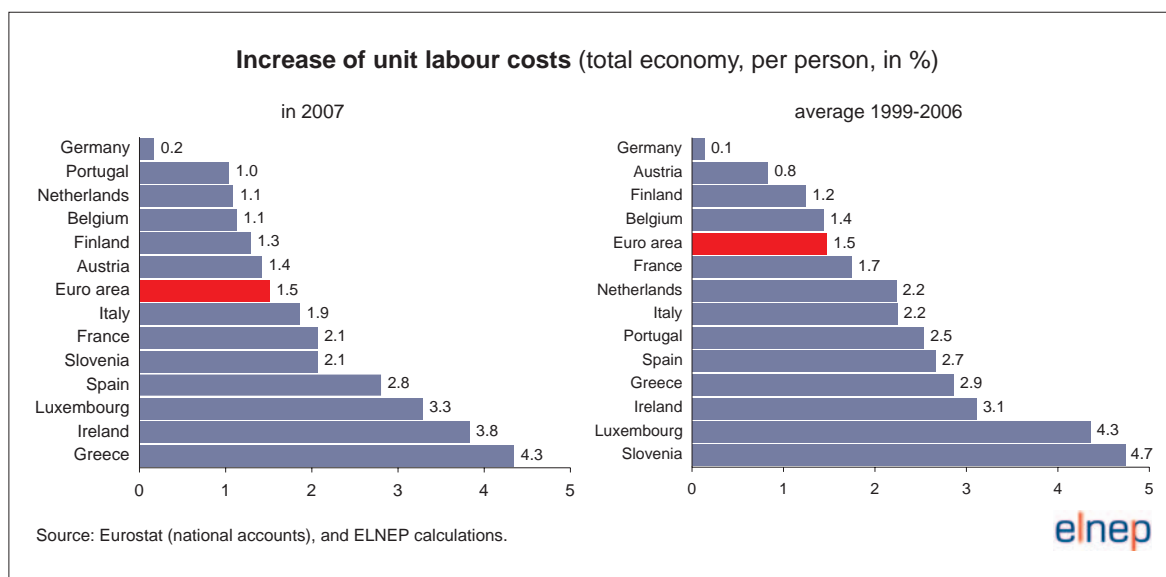
Figure 8 shows the country breakdown for hourly labour costs over the period and for 2007. Many euro area countries have kept relatively close to the average figure, at least over the period as a whole. Strikingly, Austria and Germany, the largest EMU member, have undershot the average by more than one percentage point over the whole period (although in 2007 Austria accelerated markedly to above the annual rate of growth). At the other end of the distribution this was offset by three countries, Spain, Greece and Slovenia with nominal hourly wage growth in excess of 4% up to almost 8% a year. Luxembourg and the Netherlands are a mirror of Austria, decelerating after an earlier period of

substantially above-average wage growth to below average in 2007.

Such increases need to be seen in the context of the growth of productivity. It is changes in unit labour costs (ULCs) – wage minus productivity growth – that is decisive for firms' costs and thus for inflationary pressure, and consequently for countries' external competitiveness. Figures 9 and 10 present two measures of ULCs, in terms of persons and of hours. This scarcely affects the country rankings, but it does change the absolute numbers; we focus here on the more important hourly data, with some reference to the person-based data for 2007, not yet available on an hourly basis.

Immediately striking is the negative ULC development in Germany over the period, which actually intensified in 2006 and, on the basis of the 2007 data based on persons, has not abated despite the recent strong improvement in the German labour market. These numbers imply a persistent, not just disinflationary, but deflationary effect

Figure 9



coming from German wage-setting (given the country's productivity trends). Taking the implicit ECB inflation target of 1.9% as a benchmark, the euro area average rate of ULC growth, at 1.0%, is almost a full percentage point lower. Spain, Greece and Portugal were only marginally higher than the target rate of inflation – although 2007 saw a major acceleration in Greece. Ireland and Slovenia, with substantially faster ULC

growth, are very small members; Slovenia has only just joined the euro area and corrected sharply in 2007. In the aggregate, then, ULC growth has been disinflationary during the entire course of EMU, and remained so in 2006 and 2007 despite the tightening labour market. Wage growth has thus served to offset the upward pressures on inflation resulting from higher imported prices, notably for energy and recently food.

Figure 10

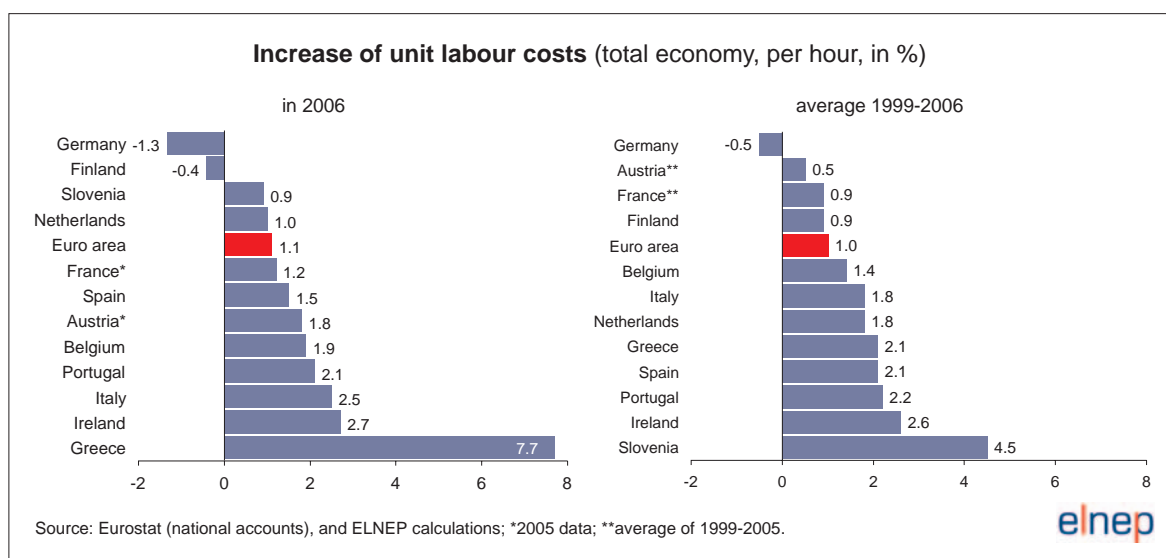
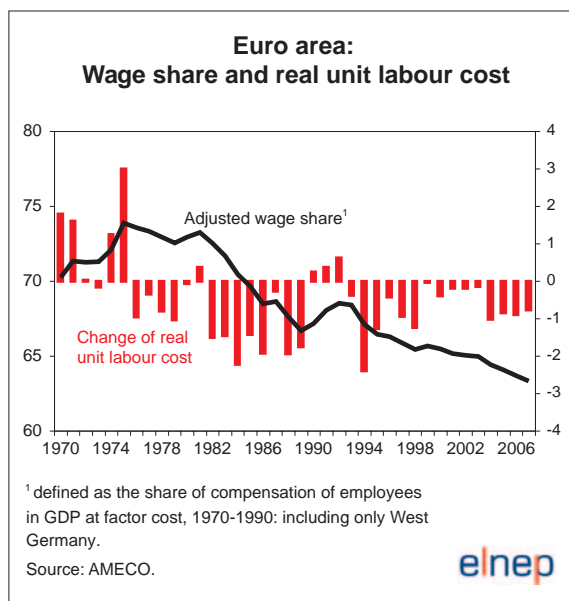


Figure 11



A consequence of this disinflationary wage policy coupled with above-target actual inflation can be seen in Figure 11. Unit labour costs measured in real terms (i.e. real unit labour costs, RULCs) have been negative, so that the share of national income going to labour has been declining. This marks a continuation of a longer-term trend. Since the start of EMU labour's share of income has dropped by – a further – 2.5 percentage points of GDP. It is about 7p.p. lower than in 1970 and more than 10 points of GDP below its high-point in the mid-1970s. This trend has given rise to a wide-ranging debate among international institutions and policymakers, the tenor of which is that steps must be taken to ensure that the 'fruits' of globalisation are shared more fairly. Doubts have also been cast on the informational content of the wage share (pointing, for instance, to the fact that working and retiree households also draw income from capital and to more technical issues relating to treatment of the income of the self-employed).² This debate cannot be entered into here. It should be pointed out,

though, that the root cause of the declining wage share is the fact that wage increases have consistently lagged behind the sum of productivity and inflation. It is rather disingenuous of policymakers such as the OECD and the European Commission³ that explicitly recommended wage growth lagging in this way (to 'create room' for job increases) to be surprised or concerned by the fact that the wage share has fallen so dramatically.

Alongside the overall rate of nominal ULC growth, Figure 9 raises the serious issue of competitiveness *within* the euro area. Countries with sustained ULC growth below the euro area average – especially Germany – have improved their competitiveness vis-à-vis the other members: within a monetary union, exchange rate movements are not available as a compensating mechanism. The mechanical counterpart of this is a loss of competitiveness among countries with above-average ULC growth. This is not necessarily a problem, if it represents a correction of previous imbalances. Also countries with a low price level may be expected to have faster ULC (and price) rises as part of a price-level convergence process. However, if sustained – and the figures are annual averages over a seven-year period – above-average ULC growth can cause a substantial loss of competitiveness.

² European Commission (2007) Employment in Europe Report 2007, Chapter 5: http://ec.europa.eu/employment_social/employment_analysis/employ_2007_en.htm

³ In the so-called Delors Report: Growth, Competitiveness, Employment: The Challenges and Ways Forward into the 21st Century - White Paper, COM(93) 700, December 1993.

Indeed we see that over the life of EMU Germany's current account position has moved from a deficit of 1% to a huge surplus of 8% of GDP; meanwhile Spain has chalked up the largest current account deficit in the world as a share of GDP: 10% in 2007. Such competitive disequilibria are unsustainable in a monetary union. If competitive pressures do not lead to a correction EMU might collapse. Although there are some differences, countries such as Spain potentially face an 'Argentina scenario' in which boom quickly turns to bust, and the previously beneficial exchange rate peg (EMU membership) becomes a huge millstone around the economy's neck.

To avoid this and ensure balanced development within EMU, wage increases need to be oriented towards the medium-run rate of national productivity growth (plus an inflation component compatible with overall price stability). ELNEP has consistently argued for this.⁴ It is important to note, however, that this does not mean – as many European policymakers seem to think – that all countries should emulate Germany: clearly not all countries can have below-average ULC growth. ULC increases that undershoot the average are as important to correct as countries that overshoot. In some countries oligopolistic market structures reduce price pressure on firms and encourage them to raise prices despite wage moderation: a sensible agenda of product market reforms may well be a useful adjunct to a balanced wage policy in such cases.

⁴ See past reports available from www.elnep.org. See also Watt, A. (2007) 'The role of wage-setting in a growth strategy for Europe', P. Arestis, M. Baddeley and J. McCombie (eds.) *Economic growth. New directions in theory and policy*, Edward Elgar.

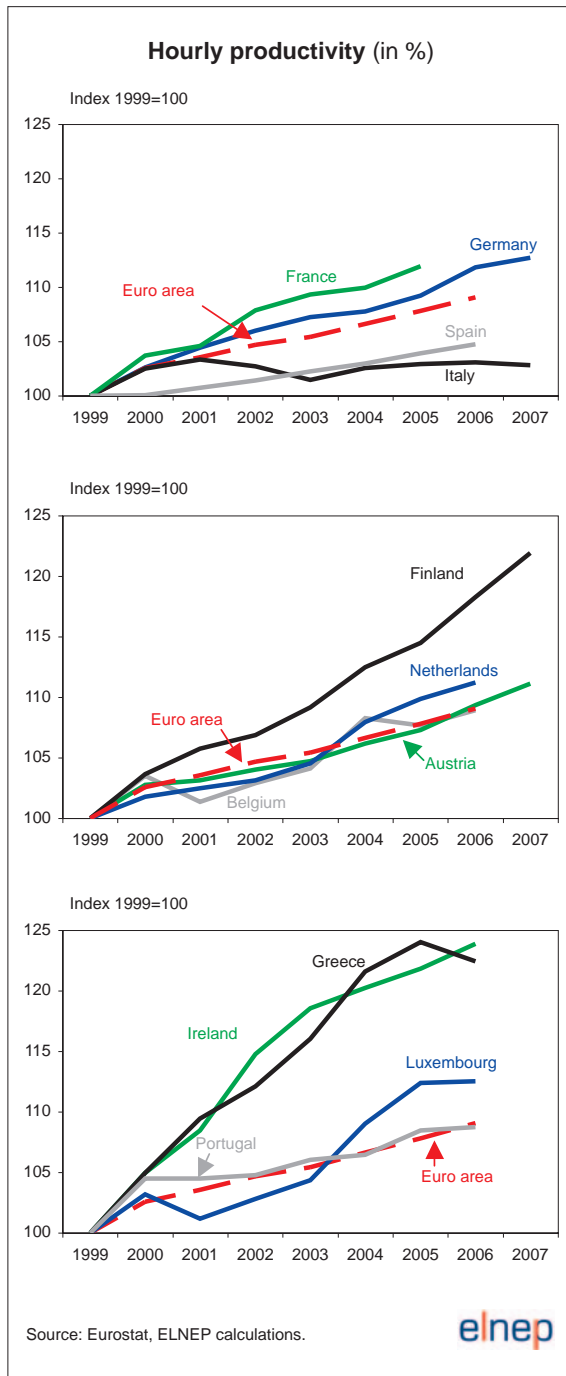
Productivity growth – a worrying slowdown

In a model of balanced economic development, productivity growth is the key driver of rising wages and living standards. Productivity growth cannot be decreed from on high, however. Productivity outcomes result from a complex and imperfectly understood mix of capital investment, education and training measures, efficient work organisation, input of modern technology, and workers' motivation and commitment. The Lisbon target of making Europe the most dynamic knowledge economy in the world calls for workplace re-engineering, aimed at changing European business into high-performance work organisations. A key – although not the sole – task of government policy is to set incentives in such a way as to encourage workers and investors to steadily raise productivity through these different channels.

Figure 12 shows hourly productivity trends in the euro area countries since 1999. The graph shows that, in 2006 each hour of work generated about 9% more in output (after allowing for price increases) than in 1999. This increase is 'available' for rising living standards or also to reduce working time and increase leisure.

The figure shows that most euro area countries are experiencing productivity growth quite close to the euro area average. Four countries have enjoyed remarkably fast productivity increases: Finland, Greece, Ireland and Slovenia. It would be tempting to treat this, in all but the first-mentioned case, as a typical 'catch-up' phenomenon: countries with a lower income level have

Figure 12



more scope to raise productivity by increasing capital investment and benefit from sectoral change to high productivity sectors. Such a diagnosis is called into question, however, by the fact that the two countries with substantially below-average

productivity growth are Italy and, above all, Spain.

The numbers suggest that, after an encouraging start, something occurred to drag Italian productivity seriously downwards. Spain, a potential ‘catch-up country’ seems to be on a structurally low productivity growth trajectory. What could explain these trends (which, while primarily an issue for the countries concerned, do serve to drag down the European average performance)? The boxes offer a tentative first answer.

In Italy a comparative examination of labour productivity performance shows a true collapse of the Italian international position: according to Eurostat estimates, in 1999 the Italian score in hourly productivity, measured in purchasing power parities, was 102 (100 being the EU15 average), while in 2006 it was 90. Very similar results are obtained whatever the measure of productivity.⁵ This outcome is rooted in the negative macroeconomic interaction between a still insufficient competitiveness of the product market and, in the labour market, the combination of rapid growth of flexible jobs and persistent wage moderation, even in the face of an unemployment rate that has fallen beneath the European one. This negative interaction has led to an unwanted employment-productivity trade-off in a context of increasing rents and lost competitiveness.⁶ The current Italian debate discusses the need to increase competitiveness in the sheltered sectors through a further liberalisation effort. Collective bargaining also has an important role to play. While the need to increase domestic demand by enhancing the purchasing power of wages and pensions through a one-off tax reduction

has been repeatedly announced during the just-ended electoral campaign by the winning political party, social partners are discussing how to modify the architecture of the Italian wage bargaining system (the so-called '93 Protocol). The aim is to strengthen the role of collective bargaining as a stimulus to local wage bargaining, in the framework of a new social pact for productivity and growth, based on workplace reorganisation. The main items for discussion are the extension of industry-wide collective wage agreements with a duration of from two to three years, and the use of national agreements as a stimulus to (and at least temporary substitute for) local wage bargaining.

In **Spain** economic growth, unlike in Italy, has been rapid, but it has been based almost entirely on employment increases while productivity growth has been minimal. Such a growth regime logically has a limit: employment, especially in ageing countries like Spain, can not grow forever and immigration inflows or a larger female workforce can only postpone the stationary state. A low capital to labour ratio has not been the problem: the increase was not far below the EU15 average. In fact investment, not only in housing but also in plant and machinery, has been growing rather fast during this period. The major problem is that total factor productivity (TFP) growth, whose main determinant is technological progress, has been very low (less than a quarter of the EU15 average). The principal cause of stagnating productivity is the slow progress in adopting more efficient technologies. The R&D to GDP ratio is one of the smallest in the EU, below 50% of the most advanced countries. For years innovation has rested largely on foreign

capital while domestic firms R&D expenditure has been always very low. The loss of the attractiveness of Spain for multinational firms during the past years, looking for greener pastures in emerging and eastern Europe countries, has aggravated the trend.

Regarding human capital, school enrolment in secondary and higher education is at comparable levels to other high developed countries, but low performing scholars (as OECD-PISA reports show) and low career-development incentives for researchers are clear pitfalls. Another major problem in this respect has been that, following labour markets deregulation policies during the 80s and 90s, firms have used and abused temporary contracts, making high work rotation a clear disincentive for training and further investment in human capital at the working place.

Last but not least, during the past boom in which the housing sector has reached more than 10% of GDP and where tourism and low-cost services have represented a high share of total GDP, the economic structure has shifted clearly towards less technological demanding activities. This shift towards low productivity growth sectors has been in part the consequence of high immigration inflows during the last years. Immigration has had a composition effect upon factor endowments towards a low skilled labour force, making the Spanish economy more inclined to specialise in sectors intensive in low skilled labour, with low wages and low productivity.

⁵ See the EU-KLEMS Project site: <http://www.euklems.net/>.

⁶ Tronti L. (2007), "The July Protocol and Economic Growth: The Chance Missed", in Acocella N. and Leoni R. (eds.) (2007), *Social Pacts, Employment and Growth*, Physika-Verlag, Heidelberg, pp. 69-96.

This raises a wider and important issue. Earlier it was emphasised that (real) wage growth should be in line with productivity. However, causation must also be assumed to flow in the opposite direction, from wages to productivity. At the aggregate level, wage growth lagging behind the (initial) rate of productivity growth has the effect of pricing workers into work (provided macroeconomic policy ensures that aggregate demand growth is sufficiently strong). But this also changes, over an extended period, firms' mix of factor inputs. Other things equal they reduce the input of capital per unit of labour. As capital intensity is an important determinant of productivity this tends to slow the rate of productivity growth. At the level of the company, relatively cheaper labour means – on a standard microeconomic analysis – that firms have less reason to treat labour as a 'scarce good' to be deployed in production as efficiently as possible.

It seems likely that a central culprit in this regard is the decentralisation of collective bargaining. Increasingly firms in euro area countries have sought and found ways to permit them to deviate downwards from sectoral or national collective agreements. They have insisted on so-called 'opening clauses', have increased the extent of local or plant-level bargaining or have simply withdrawn altogether from sectoral-level bargaining institutions and mechanisms. Whereas in the past firms were forced to 'raise their game' by the pressure coming from centrally agreed wage increases (the so-called 'productivity whip'), firms have increasingly been able to force pliant company and plant-level worker representatives to make concessions on wages, avoiding the necessity of 'painful structural reforms' within the company.

This suggests – once again! – that the best wages policy is for balanced growth in step with productivity, and not a policy of wages lagging productivity, as, quite apart from possible negative impacts on aggregate demand, this risks forcing down the rate of productivity growth, and thus the benchmark for further wage increases. European trends suggest that this mechanism has been in play in recent years in Europe. The answer is a productivity-oriented wage norm and a return to collective bargaining that establishes a fixed price for labour across the relevant market.

Job quality and pay inequality⁷

The European Union's Lisbon Strategy was explicitly not just about raising the employment rate, but about 'more and better jobs', that is also about issues of the quality of employment. This is a broad field that cannot be done full justice to here. We consider two important issues in turn: the increased use of 'non-standard' employment contracts, and the problem of widening wage differentials and the issue of low pay. We conclude with an attempt to quantify progress (or regress) in job quality in the EU countries using a composite indicator of job quality.

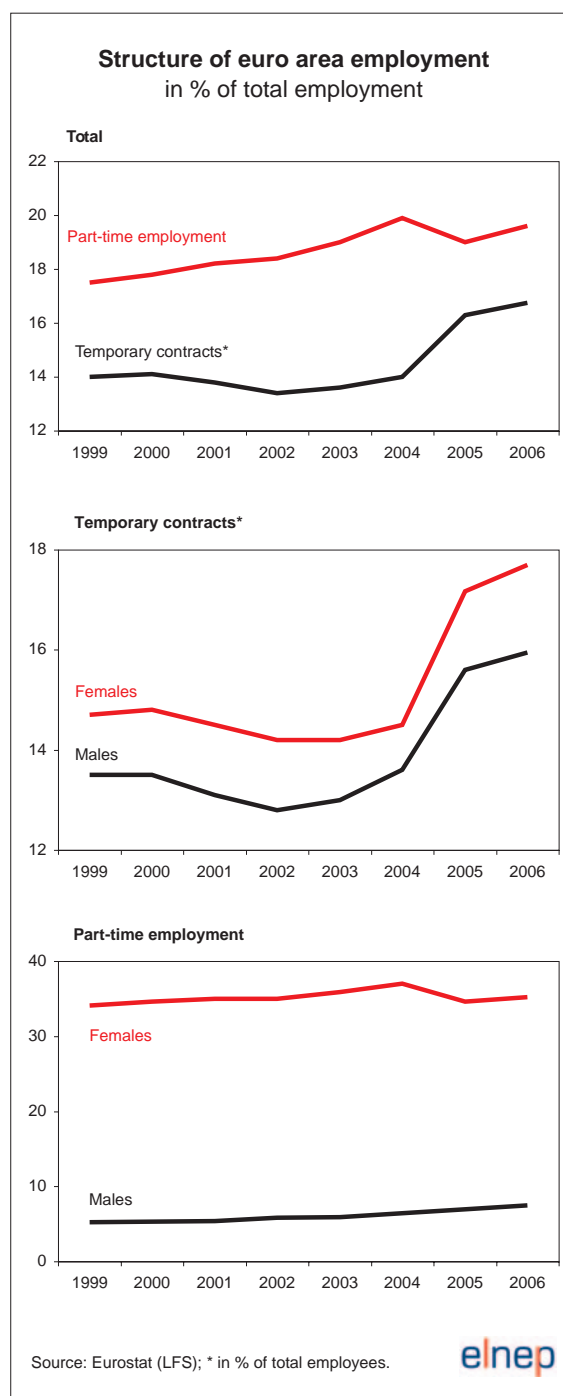
⁷ Thanks to Wiemer Salverda, AIAS, for his contribution to this section.

Non-standard employment

Figure 13 shows the steady increase in both part-time and temporary contracts⁸ in Europe: both have risen by more than 2 percentage points of employment since 1999. One in five workers in the euro area works part time. One in six has a temporary contract; the two groups overlap to a considerable extent. Temporary contracts, in particular, seem to be in part a cyclical phenomenon: the proportion working on such contracts declined when labour markets tightened in 2001, only to rise sharply as the period of economic stagnation lengthened; the recent improvement in labour markets and thus the bargaining position of workers does not, however (yet) seem to have reduced the incidence of temporary contracts, although the rate of growth has declined. By contrast the part-time share appears to be on a secular upward trend.

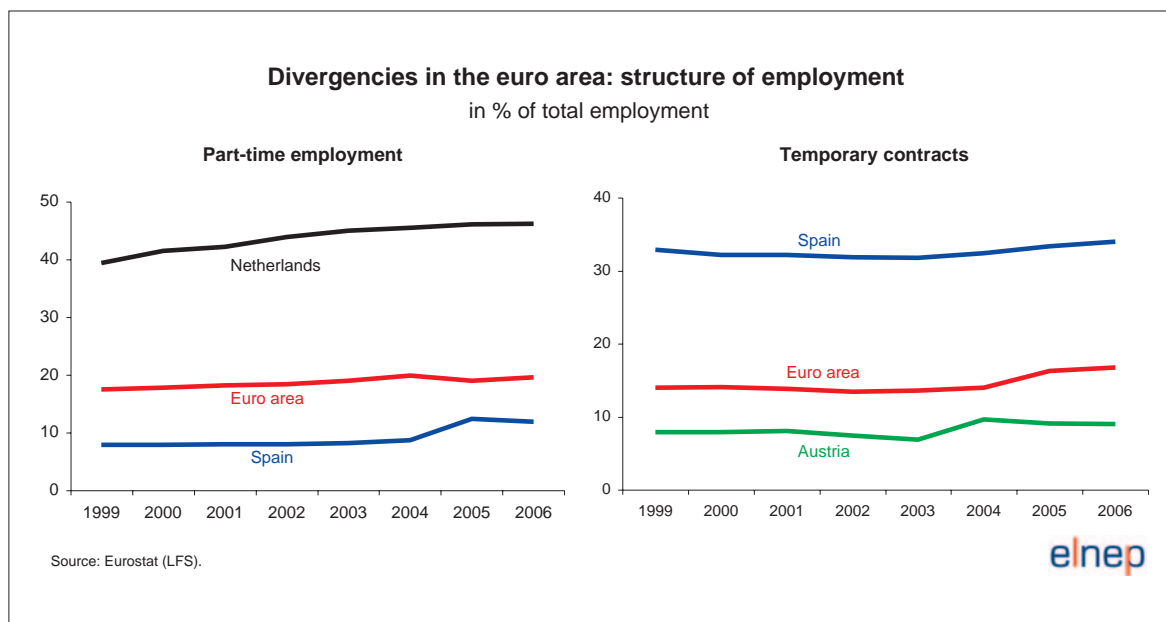
While women workers are slightly more likely than their male colleagues to be on fixed-term contracts, the gender divide is particularly stark in the area of part-time work: more than a third of women are employed part-time, making the term ‘non-standard’ inapplicable for this group. Part-time work remains a marginal phenomenon for men, although the male part-time share has risen by almost half since 1999. For the area as a whole there is no substantial difference in part-time shares between different female age groups (in some individual countries there are major differences, but they average out); part-time shares do vary with skill level, however, high-skilled women being less likely to take part-time work. By contrast fixed-term

Figure 13



⁸ We use the term ‘temporary’ here as it is that given in the Eurostat documentation. It should be made clear that it is not limited to those working for temporary employment agencies, but essentially consists of those whose employment duration is fixed in advance (‘fixed-term contracts’), rather than being unlimited. Depending on the nature of temporary employment agencies, agency workers may in fact not be included in this definition (if their contracts with the temp agencies are ‘permanent’ contracts).

Figure 14



contracts are primarily a phenomenon of young workers.⁹

Figure 14 illustrates the extent of intra-EMU divergence regarding non-standard contracts. Interestingly, Spain, along with other southern European countries, still makes very little use of part-time work, but is the country of *precariedad*: around one in three workers lives with the insecurity of a fixed-term contract. The Netherlands is well known as the ‘part-time economy’: the part-time share continues to rise inexorably, and is set to reach 50% in the near future.

The issue of whether such contracts are chosen by workers, whether they are ‘voluntary’ or ‘involuntary’, is a thorny one. Survey responses need to be interpreted carefully and depend to a great extent on the

range of responses offered: a key issue is whether (especially) women consider a part-time job that is taken to allow for child-care to be a ‘voluntary’ choice or not. Clearly this depends on the existence of collective or family-based alternatives. According to the European Labour Force Survey, around 30% of part-timers (more for men, less for women) explicitly stated that the main reason for working-part-time was that they ‘could not find a full-time job’. Conversely around 17% stated explicitly that they did not want a full-time job. This leaves around half of the part-timers whose voluntary or involuntary status is debatable; particularly in the case of students financing studies and, above all, women working part-time, who would very possibly prefer a full-time job if adequate child-care facilities were available. While similar considerations apply in principle to those on fixed-term contracts, here the verdict of European workers is much less ambiguous: almost two-thirds of those working on fixed-term contracts explicitly state that they only do so because

⁹ Further details on non-standard employment in Europe can be found in the ETUI-REHS Benchmarking Working Europe Report 2008: 33ff.. Available under: <http://www.etui-rehs.org/research/Publications/Regular-publications/Benchmarking-Working-Europe/Benchmarking-Working-Europe-2008>

permanent employment was not available (this is consistent with the cyclical pattern described above).

Wage inequality and low pay

Alongside the shift in ‘functional’ income distribution from wage-earners to capital-owners described earlier, widening income disparities between wage-earners have also been a worrying feature of recent years. New results from extensive research on low-wage employment in Europe and the United States show a rapid increase in the incidence of low pay. A number of western European countries, most notably Germany, have increasingly taken on an ‘Anglo-Saxon’ character in terms of pay inequality, while others – especially Denmark – have stabilised the low pay incidence at comparatively low levels.

Russell Sage has just published a series of country monographs¹⁰ on the situation of low-wage work in Denmark, France,

Germany, the Netherlands and the UK, presenting the results of a four-year research project initiated by the US-based foundation of the same name.

Five leading research institutes¹¹ have taken stock of the nature and evolution of low pay in their countries and performed in-depth case studies of low-wage occupations in 200 establishments in five industries: retail trade, hotels, call centres, food processing and hospitals. A number of very interesting results were found:

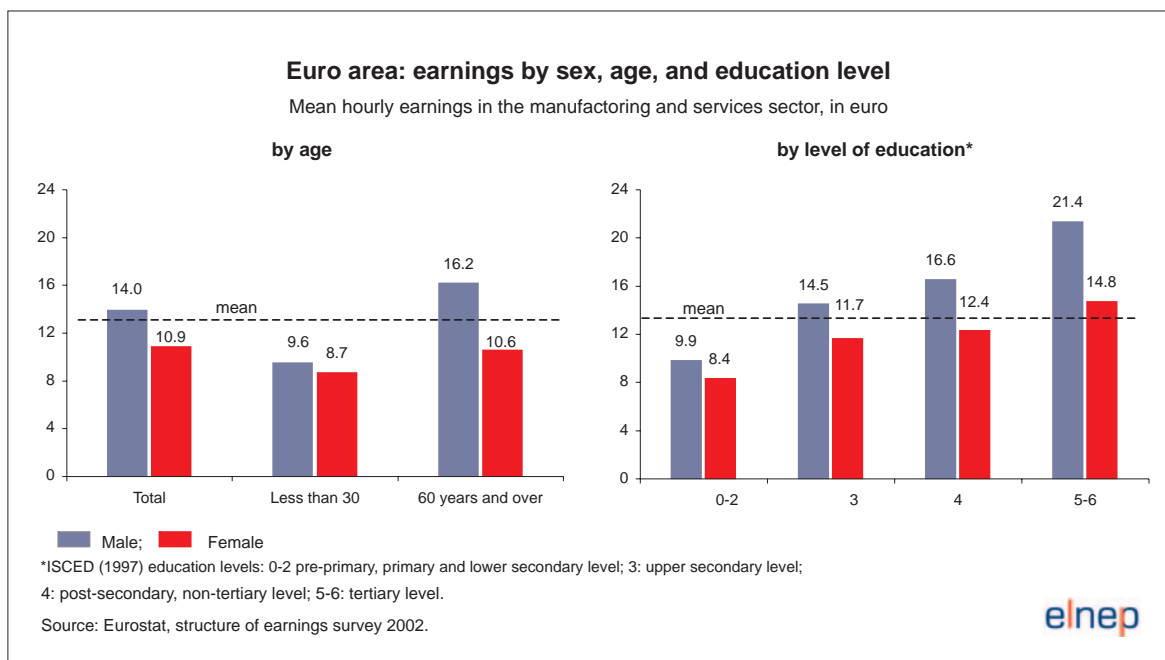
- Germany – and to a lesser extent the Netherlands – have registered a strong increase to levels of low pay comparable to the UK and US;
- both the lowest level, in Denmark, and the highest level (in the US) have been remarkably stable over recent decades;
- the quality of working conditions of the low-wage jobs as such is not always better in Europe, but the jobs’ social conditions – health care, paid holidays, etc. – certainly are;
- people move out of low pay more easily when the incidence in the country is lower.

¹⁰ See www.russellsage.org/publications: Country monographs on *low-wage work for Denmark, France, Germany, The Netherlands and the United Kingdom*.

¹¹ Århus School of Business **ASB**; Université Paris-I, Université Paris-X and Ecole Normale Supérieure ENS, Paris; Institut Arbeit und Qualifikation **IAQ**, Duisburg-Essen; Amsterdam Institute for Advanced Labour Studies **AIAS**, Amsterdam and **STZ** Consultancy, Eindhoven; National Institute for Economic and Social Research **NIESR**, London and ESRC Centre on Skills, Knowledge and Organisational Perform **SKOPE**, Oxford/Cardiff.

Percentage of employees being low paid*, 2003-2005					
Denmark	France	Germany	Netherlands	United Kingdom	United States
8.5	11.1	22.7	17.6	21.7	25.0
<p>* Earning less than two-third of the median hourly wage. In addition, France, Germany, the Netherlands and the UK have significantly more self-employed in the low-earning parts of the economy than Denmark and the US.</p>					

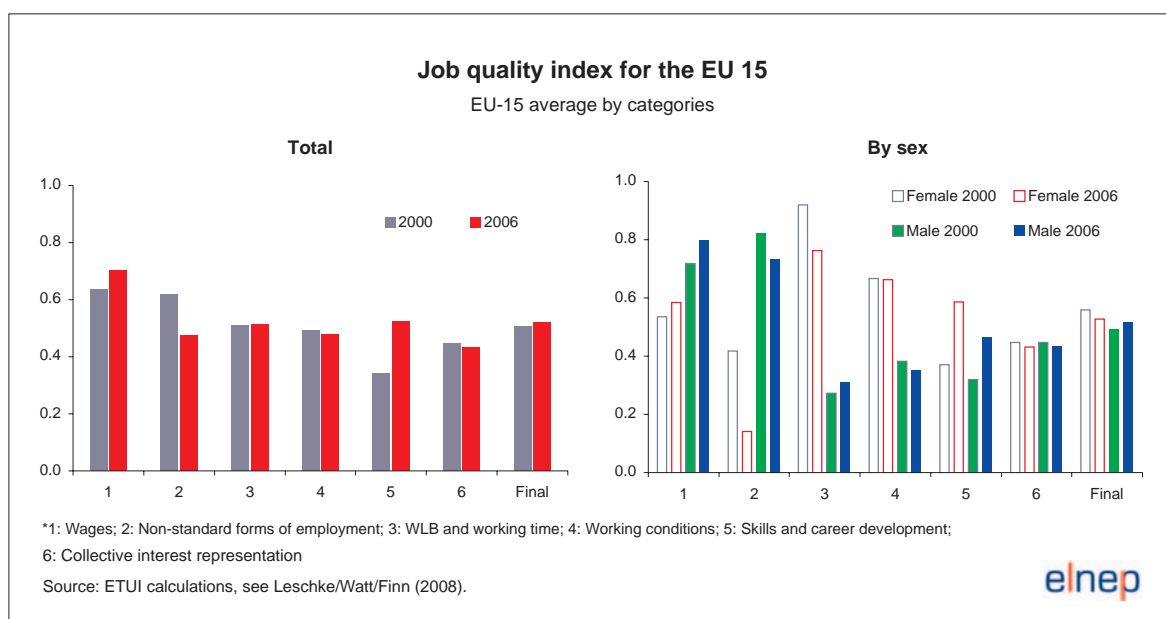
Figure 15



These results have several important implications. First, the main differences in low pay are now found within the EU and not so much between Europe and the US. Denmark, for instance, is setting an important example and there are no good reasons why other EU countries could not follow 'best-practice' countries. Second, the stable but very different incidence of low pay in the US and Denmark – while employment rates are similar, and unemployment much lower in the latter – throws up the question if labour-market institutions can really be blamed for unemployment and unemployment growth. Third, the growing mass of the low paid in Germany seems to request improved labour protection by a minimum wage or collective agreements. Last but not least, social security provided to all, and thus available to the low paid, in Europe deserves support and protection to avoid in-work poverty US-style.

As can be seen from Figure 15, pay inequality has important gender, age and skill dimensions. According to figures from the EU Structure of earnings survey, in 2002 the overall gender pay gap was a substantial 22% (per hour, so not allowing for gender differences in working hours). It is noteworthy that the differences is rather small for younger workers, but rises to around 50% for older ones: this clearly indicates the wage penalty of women's de facto greater responsibility for tasks outside paid employment (child-care, housework). More generally the age effect is substantial: despite the higher (formal) skills of younger cohorts, those over 60 earn around half as much again per hour compared with those under 30. The second panel shows that 'education pays' – especially for men. Men with the highest formal education levels earn more than twice as much per hour as their low-skill counterparts; the skill premium is considerably less pronounced for women.

Figure 16



Assessing job quality

Job quality is clearly a multi-faceted phenomenon. In order to assess whether Europe is indeed creating ‘better’ as well as ‘more’ jobs, what is needed is an indicator of job quality that is comprehensive, comparable, European in scope and timely. The ETUI research department has sought to contribute to this aim by creating a composite European Job Quality Index.¹²

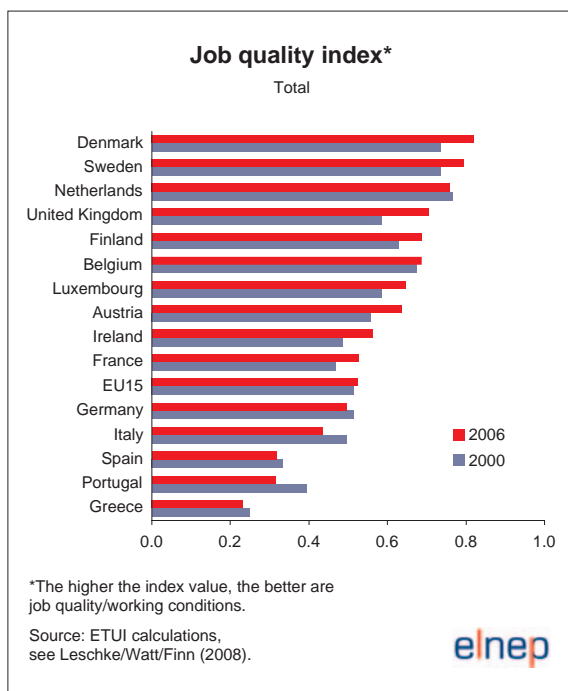
The following provides a brief overview of the preliminary results for the EU15, comparing data for 2000 and the most recent year for which data was available (which for different indicators was 2005-7). The EU15 JQI consists of a total of fifteen different indicators (some of which are themselves

composites) which are weighted and collated into six sub-indices. These are: wages, non-standard forms of employment, work-life balance/working time, working conditions, skills and career development, and collective interest representation. The data for these different indicators – which are collated separately for ‘total’ and for men and women – are normalised in such a way that the worst-performing country gets a score of zero, the best performer one. By using the best and worst scores for ‘total’ in 2000 to normalise the figures for 2005-7, it is possible to assess whether countries (and the EU15 as a whole) have improved or declined in terms of job quality along the different dimensions, to rank countries in each year, and also to bring out gender differences. The JQI results for the EU15 are presented in Figure 16, while Figure 17 indicates the country rankings in 2000 and 2005-7. In both graphs higher values indicate higher job quality. Overall the JQI paints a mixed picture as to how job quality has developed in the different dimensions.

¹² Work on the JQI is on-going. Details on the construction of the JQI can be found in a working paper that can be downloaded from: <http://www.etui-rehs.org/research/activities/Employment-and-social-policies/Reports-and-discussion-papers>. The limitations of the JQI caused primarily by data constraints are set out in detail there. A slightly different index, to be updated annually, is also being calculated for the EU27.

- Quality along the ‘wages’ dimension – which considers real wages at purchasing power parities and an in-work poverty measure – has improved, as might be expected. However, a number of countries (e.g. Portugal, Spain) experienced a decline in their score, reflecting stagnant or even declining purchasing power of average wages and/or an increase in the risk of in-work poverty. There is a roughly parallel improvement for both men and women in the EU15 as a whole, maintaining the substantial gender pay gap.
 - We see a significant deterioration in terms of the incidence of non-standard forms of employment (involuntary part-time and temporary employment), reflecting in particular an increase in the proportion of part-timers reporting that they actually wanted a full-time job, coupled with a smaller rise in the overall part-time share; the impact of the rise in temporary work is less pronounced. The figures confirm the well-known cross gender gap in the incidence of involuntary non-standard contracts, and the gender gap has widened over time.
 - There has been little overall change in the sub-index work-life balance and working time. This indicator reveals a major gender gap, suggesting that *per se* women’s paid employment offers greater compatibility with other areas of life. Of course the prime driver of this is women’s greater *de facto* responsibility for non-work areas such as child and elderly care. Moreover, the job quality decline was marked for women, whereas men experienced an improvement.
 - A rather similar picture emerges for ‘working conditions’, which pools a whole series of reported physical job characteristics, work autonomy and stress, and also health and safety. Perhaps surprisingly in view of the shift from industry to services, there is actually a slight overall decline in this index. Again, as defined here, there is a substantial gender gap in women’s favour, reflecting notably sectoral segmentation in most countries.
 - A welcome development is the overall improvement in the index for skill and career development (although data limitations meant that the comparison is based on a single indicator, the proportion of adults in education training, which may conceal changes in training duration and quality). Taken at face value it suggests that the policy recommendation for more life-long learning is having some effect.
 - The indicator of collective interest representation (for which no gender disaggregation was possible) indicates a decline over time, albeit a small one, reflecting the fall in unionisation rates in most European countries.
- It is difficult, of course, to weigh the importance of these sub-indices in any plausible way. The ‘final JQI’, is simply the unweighted average of the six sub-indices and points to an – almost imperceptible – improvement in overall job quality between 2000 and 2005-7 in the EU15. As is clear from the graph, this reflects a mix of improvements in some and set-backs in other areas. If one sets aside wages, which might be considered to have a ‘natural’ tendency to rise on average, the trend

Figure 17



three non-euro area members clearly outperform those in the common currency area. It is the southern European countries that, on this measure, perform least well in offering high quality jobs.

It is noteworthy that the countries towards the top of the index tend to have low unemployment rates, with Belgium as an exception, while conversely those countries that the JQI suggests have a problem with job quality are amongst those with the highest unemployment rates. It is surely not the whole story, but this does suggest that lower unemployment has the additional indirect beneficial effect of strengthening the bargaining position of employed workers and, other things equal, forcing employers to offer their employees (more) decent work.

appears on balance to be towards declining job quality. Whatever the weaknesses of the JQI as an indicator, even a cautious interpretation would be that the EU15 countries are, on average, not clearly moving towards 'better jobs'. The gender differences in the different sub-indices are substantial, so the fact that there is little gender difference in the overall job quality index is hard to interpret meaningfully. Tentatively, though, the indicator suggests a slight closing of the gender gap in terms of job quality (although this, too, is sensitive to the relative importance given to the sub-indices).

What is rather worrying is the trend over time in the high and low performance countries, against the background of the more or less constant figure for the EU15. Almost all of those countries with good performance in 2000 saw a further improvement in subsequent years, whereas the poor performers suffered a decline in their JQI (particularly strongly in Germany and Italy). This suggests a widening of differentials within (western) Europe, in terms of the aspects of job quality captured by the index.

Figure 17 shows the country rankings of this overall JQI in the two years. The ranking on the most recent data reveals high scores for the two Scandinavian countries Denmark and Sweden; the other Nordic country, Finland, also performs well. Adding the UK, in fourth place, to Denmark and Sweden, the

Conclusion

In many important senses the euro area labour market performs better than its widely held reputation would suggest. Most notably, job growth has been strong, especially for women, and unemployment, although still higher than in the US, has fallen markedly. Europe has indeed created 'more jobs'. However, there are a number of serious issues in the area of 'job quality' in the broad sense. Real wage growth has been sluggish and pay inequality has risen. The use of non-standard contracts (not freely chosen by workers) has grown steadily. The rate of labour productivity growth is much too low.

This report has suggested that these developments may be linked. It seems that returning to pay developments that are oriented towards medium-run productivity growth would be an important step towards raising workers' living standards, would help stop the trend to greater inequality, but also serve to stimulate the rate of labour productivity growth on which, ultimately, rising living standards depend.

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